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*(The opinions expressed in articles in The Canadian Chartered Accountant are the opinions of the writers of the articles and are not necessarily endorsed by the Association.)*

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## Editorial Comment

### *Third Published Index*

The Editorial Committee brings to its readers this month the third index prepared in connection with THE CANADIAN CHARTERED ACCOUNTANT, the other two having been published in 1931 and 1935. It includes the contents of all the numbers of this Magazine published between July 1935 and June 1939—volumes twenty-seven to thirty-four—and in addition a list of contributors for this period. As might be expected in a publication such as this, there are particulars on current topics which in time lose their significance. A perusal of the index however shows that in these forty-eight numbers of the Magazine there have been published numerous articles on accounting, economics, finance and taxation which, with the summaries of court judgments on matters of professional interest to members, form an accumulation of valuable material for the library of the accountant.

### *Provision in Will to Pay Income Tax*

An interesting conflict of views was disclosed in a motion brought before the supreme court of Ontario for construction of the will of the late Sir Albert Edward Kemp. In commenting on the judgment, the editor of the *Dominion* points out that it is the first Canadian case upon the question.

The testator directed his executors to maintain his residence property for the benefit of his widow and to pay her a fixed sum monthly for expenses of maintenance of the houses and buildings. He also directed that the provision for his wife should be a first charge upon his estate and that any succession duties and all income taxes which might be payable in respect of the provision in question for his wife should be paid out of his estate by his trustees.

Lady Kemp was in receipt of other substantial income from the estate and had also both before and after the death of the testator an independent income from other sources, with the result that the additional income deemed to be received by her by reason of the provision in the will with respect to the residence property and the maintenance thereof increased the rate at which the higher portion of her income was taxed. It was contended on Lady Kemp's behalf that that portion of her taxable income derived by virtue of the provision in question should bear the highest rate of taxation applicable to any part of her income, and the single judge, before whom the application was first brought, gave effect to her contention. The court of appeal by judgment rendered on 27th March 1939 reversed this ruling however, holding that, as a separate levy was not made by the *Income War Tax Act* in respect of the several component parts of the taxable income, no distinguishable part of her income tax was computed upon that part of her income deemed to be received by virtue of the particular provision in the will. Accordingly, the principle adopted in England was followed, namely, to take a proportionate part of every dollar of the tax as payable in respect of each particular part of the income.

There was a further difficulty. The income tax paid by the trustees for Lady Kemp was deemed by the *Income War Tax Act* to be additional income received by Lady Kemp and, therefore, tax would be payable with respect to it. The court of appeal reversed the judgment of first instance, holding that it was impossible to read the words, "all income taxes which may be payable in respect of the said above provisions for my wife," as including an additional benefit not within the provisions of the clause giving Lady Kemp the use of the house and the maintenance thereof. In other words, the income tax payable on this additional income was not to be borne by the estate.

*Accounting  
Practice and  
Legislation*

It may be said that the provisions of the Dominion companies' act and of the companies' acts of the Provinces as to the form in which accounts shall be presented and concerning auditors and their duties represent only minimum requirements in those respects. To the practising accountant the reason is obvious. Because of the very nature of his work, legal requirements must lag far behind the professional standards of the public accountant.

In a memorandum submitted some time ago to the senate committee on banking and currency in the United States, George O. May, one of the distinguished members of our profession, explained the lack of statutory enactments in this respect, and his observations should help members to make this clear to the layman. The committee was at the time considering a provision of the securities exchange bill which was to confer on a regulatory body not only the power to prescribe the form in which accounts of corporations shall be presented but also how profits shall be computed. "I have stated, and it cannot be too often repeated," he said in opposing the provision, "that accounts necessarily represent the result of the application of appropriate accounting principles and judgments to facts. Upon the soundness of the judgment employed first in choosing and then in applying the guiding principles depends the value of the resulting accounts. Sound judgment can be based only on intimate knowledge and ample experience, and its exercise should be attended with responsibility . . . The idea that uniformity can be attained and the exercise of discretion rendered unnecessary by rules, however detailed, is entirely illusory. . . Uniformity necessarily means a uniformly low standard—indeed, laws can do no more than lay down minimum standards; higher standards can come only as the result of the recognition of ethical and moral obligations."\*

From this memorandum and from many other references in Mr. May's book the inquiring member today is given a glimpse of steps in accounting development of profound interest. One of the regrets of our Editorial Committee is that few, if any, of the older members of the profession in Canada have taken the time or shown the inclination to record in our Magazine for permanent reference an account

\*George O. May, *Twenty-five Years of Accounting Responsibility*, Vol. II, page 110.

of events and experiences which have turned out to be milestones in the history of our profession. Out of long lines of events, fresh in the memory of those of mature years, standards of practice have developed and precedents have been established, the history of which will be a closed book unless written before those taking part in such events have passed from the scene.

Much as this particular lack may be regretted we have reason to feel gratified in other respects. There is now in course of preparation a history of the provincial Institutes by a committee of each Institute which when completed will be a valuable addition to our reference library. There have been, moreover, events and happenings contributing to our professional development of which there is a permanent record. Reference books on the subjects of accounting and auditing cite a score or more judgments of the courts in this and other countries respecting auditors and their duties and responsibilities. By the publication in full of the judgments in such cases the profession receives an undoubted benefit inasmuch as the facts are instructive and the judgments themselves serve not only in some degree to supplement the accounting and auditing provisions of companies' acts, but also to impress still further upon the auditor the need of circumspection in the performance of his duties.

*Report on Auditing Procedure* And there is a source—and a very important one—that must not be overlooked. In addition to the findings of the courts there are the reports of special committees of our profession and the pronouncements of public bodies or commissions on questions within the field of the accountant, all of which are publicly recorded. Because our profession in Canada draws from the experiences of public accountants of other countries and because of the growing application of universal accounting rules and conventions, we wish to draw the attention of our readers to two reports or findings which have been released by important bodies in the United States within the past month or so.

The first is on the subject of auditing, and we hereby acknowledge the kind permission of the American Institute of Accountants to publish in this issue the report of its special committee on auditing and procedure adopted by the Institute on 9th May last. The disclosures in recent months



of conditions existing in exceptional cases in that country have prompted the profession there to examine more critically accounting procedures, and this report is a statement of the best practice for the future in regard to such matters as the examination of inventories, the examination of receivables, the appointment of independent professional accountants and the form of the public accountant's report. The report of the committee speaks for itself and we feel sure will be read with great interest by Canadian accountants.

*The Interstate  
Hosiery Case*

The second reference is to the recent findings and opinion of the Securities and Exchange Commission of the United States in the matter of Interstate Hosiery Mills\* and are worthy the attention of all members of the profession.

The case is an unusual one and was a proceeding under the Securities Exchange Act commenced by an order alleging that the Commission had reason to believe that the financial statements filed by this company with the Commission for the years 1934, 1935 and 1936 were false and misleading. Following a public hearing the examiner found that the statements were false as charged and that both the registrant and the public accountants who had prepared and certified the financial statements were at fault. According to the examiner's findings the annual financial reports of the company "included an overstatement of 'gross profit on sales' in each year covered by the statements and a resulting cumulative overstatement of the balance-sheet figures for cash, accounts receivable, inventory and surplus." These annual reports containing the overstatements were certified by Homes and Davis, a firm of certified public accountants, and the falsifications were brought about—strange as it may sound—by arbitrary changes made by the supervising senior accountant on the staff of this firm. There was no evidence of complicity in the falsification by any employee of the hosiery company or by any partner of the public accounting firm, and the motive of the senior accountant for this misconduct, observes *The Journal of Accountancy*, remains mysterious—a mental aberration is the only explanation that has been forthcoming.

\*A complete report of the findings of the Commission is published at pages 321-332 of *The Journal of Accountancy*, May 1939, the publishers' address of which is 13 East 41st Street, New York City.

*Responsibilities of Auditors and of Management* We shall not give all the details of the case as they may be read in the reference libraries of the Provincial Institutes. The two main issues in the Commission's report to which we wish to draw attention were whether the accounting firm had exercised due care in reviewing the work of their employee, and whether the management of the corporation should have discovered errors in its financial reports. On the first point the Commission states as follows:

We think it is self-evident that the review upon which an accounting firm assumes responsibility for work done by subordinates must be more than a series of perfunctory questions as to the performance of particular items in an audit program. Nor should explanations of unusual items be accepted by a reviewer without support in detail from the working papers. As a matter of principle, a review should, it seems to us, be designed with two objectives in mind: first, to insure the integration of the original work papers with the financial statements; second, a searching analysis of the ultimate facts developed in the course of the actual audit. An adequate review with the first purpose in mind should serve not only to disclose intentional or accidental misstatements, but should also serve as a method of internal check and control on the work of the firm's subordinates. This branch of the review, it seems to us, need not necessarily be carried out by a partner, but should at least be done by one well versed in the procedures adopted by the firm and in the general principles and terminology of auditing and accounting. If not a partner of the firm, such review should, in our opinion, be made by persons who are independent of those actually performing or supervising the audit work, as well as of those who prepared the draft of the financial statements. The second branch of the review is designed to enable the accounting firm to interpret intelligently the figures it has obtained and to which it is to certify. This part of the review should, it seems to us, be made by a person, preferably a partner, qualified by his knowledge of sound accounting principles and his familiarity with the accounting phases of the industry and the more important problems of the particular company. In this manner the facts ascertained by competent employees can be subjected to the independent and broader judgment of a more experienced person who can, by searching inquiry of the supervisor or senior and by examination of significant items in the work papers and schedules, reach an informed judgment both as to the adequacy of the audit work done and as to the integrity and clarity of the financial statements themselves. We are

satisfied that a review along these lines would have exposed the irregularities in this case.

The Commission also adds that "if an accountant is permitted to do original work, the whole purpose of the audit is lost."

On the second issue, the Commission gave as its opinion:

The duty to compare the Homes & Davis reports with the internal reports follows not only from the obligation to test the accuracy of the latter, but also from the obligation of the management to use all available means of assuring the correctness of its public financial statements. It is of course true that Homes & Davis were employed to check upon the internal employees, not *vice versa*; yet until all inconsistencies between the reports received from these two sources were satisfactorily explained, both sets of data were open to question.

Interstate's brief makes much of the confidence which the management "reasonably" reposed in Homes & Davis. The fundamental and primary responsibility for the accuracy of the information filed with the Commission and disseminated among the investors rests upon management. Management does not discharge its obligations in this respect by the employment of independent public accountants however reputable. Accountants' certificates are required not as a substitute for management's accounting of its stewardship, but as a check upon that accounting. In our opinion, the conduct of Interstate's management in respect of information which was to be the basis of reports submitted to stockholders and to the New York Curb Exchange and the Commission indicated a complete abdication of responsibility. They brought to bear upon the figures presented by their auditors no judgment of their own, no test from their independent acquaintance with the company's affairs, none of the purposeful skepticism which every author of a public financial statement should direct at his material.

*Form of  
Published  
Accounts*

We have the privilege of bringing to readers this month the interesting and helpful suggestions of Mr. Russell Kettle, F.C.A., on the form of published accounts. The subject of his lecture is one that engages the attention of our members every time they are called upon to add their reports to the audited balance sheets of their clients. The old contention of directors that a minimum of information in the annual published accounts is desirable in that it prevents competitors learning too much about their com-

pany's affairs is gradually losing weight. "The objective of the published accounts," as Mr. Kettle puts it, "is to provide within short compass effective means of enabling the shareholders clearly to assess and thus form an opinion upon the financial position and results and not to satisfy each and every inquiry on the part of individual members." As the Editorial Committee expects to receive requests from time to time for a copy of the lecture, a number of offprints is being made.

## THE ACCOUNTS AND AUDIT OF A FIRE INSURANCE COMPANY

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**I**N THE following article, there is no attempt to lay down a complete plan of the accounts, but rather to discuss briefly some of the items peculiar to a fire insurance company, and to indicate an audit procedure for their verification. Moreover the article will be confined to a consideration of a company operating under Dominion charter, subject to the Canadian and British Insurance Companies Act, 1932, and carrying on the business of fire insurance only.

### Revenues

(a) *New Business*—As applications are received from the agencies, they are passed to the underwriting department for approval. Here the application is scrutinized for rating, premium, classification, insurable interest, total amount of insurance, past history, etc., and when approved is passed on to the accounting department for numbering and entry in the Premium or Policy register. This procedure may be slightly altered to provide for "recording" agencies that write their own policies in the field and forward to head office a duplicate application. The Premium record is the counterpart of the sales recapitulation in the ordinary industrial or commercial firm. In view of the great volume of detail work involved and the necessity of keeping an accurate record of premiums and amounts of insurance written as between one-, two- and three-year plans and as between business written in each province, this book may best be written by a bookkeeping machine. As the application has already passed through the commissions department and has the agent's commission clearly marked on it, the machine operator records the policy number, name of insured, location, amount, premium and commission. In one operation of the machine, the premium register is written, the debit to the agent's account for the premium and the credit for the commission is posted, and the statement of the agent's account which is mailed to him at the end of each month is prepared. Another very satisfactory method is that whereby the machine operator, in the one operation, prepares a set of cards, one of which when filed

by drawers and withdrawn upon payment, forms the agent's ledger.

(b) *Renewals and Endorsements*—From the card files of insurance in force, cards are withdrawn usually two to three months in advance of expiry date. The practice among companies varies as to how often they extend the period of the policy, but in all cases they renew by certificate in each of the intervening years. Numbered renewal receipts should be prepared in duplicate and entered in the premium register in the same manner as a new policy, which is in the effective month. Endorsements calling for additional premium to be paid by the assured may be treated in a similar manner.

(c) *Reinsurance Ceded by other Companies*—It is the practice of fire insurance companies to have reinsurance agreements with other companies whereby they accept automatically all reinsurance offered, provided the other company has accepted the risk. Once each month, the ceding company furnishes to the company assuming, a bordereaux which shows the detail of each risk. Individual certificates are issued to the ceding company, but as the whole premium will be collected from the ceding company, the bordereaux is entered in the premium register for the total amount. Thus, the agency ledger contains an account for each ceding company just as if that company were an agent, which in fact it is.

When (a), (b) and (c) above are recorded and totalled for the month the columns so totalled form the basis for the general ledger posting

Dr. Agents' ledger control (Gross premiums less commissions)

Dr. Commissions

Cr. Gross premium income

From the standpoint of audit, (a), (b) and (c) above present a problem more tedious than difficult. Provided a proper internal check, the auditor can satisfy himself as to the premium income by random tests. Groups of new applications should be checked to the premium register for number, premium and commission. Special attention should be given to the calculation of commissions to determine that such are in agreement with the agent's contract. The company's regulations as to maximum amounts accepted on

individual risks should be known, and policies issued in excess of this amount should be checked for reinsurance. (See paragraph (b) under Expenditures). Duplicate copies of renewal certificates issued may be checked in the same manner by accounting for numbers, calculating agent's commission on the renewal basis, and as before, if the risk exceeds the maximum of the company, by seeing that reinsurance is placed for the balance. The reinsurance bordereaux from the ceding company represents an original invoice and requires no further check than seeing that it is properly recorded in the premium register. This check, however, should be supplemented from time to time by a test of the duplicate numbered copies of the reinsurance certificates issued to the ceding companies.

(d) *Cancellations and Rebates* — Cancellation may be at either the request of the assured or of the company. If of the assured the policy or renewal receipt for the unexpired portion of the contract must be returned. If at request of the company, registered notice of cancellation must be given and the evidence of this notice should be attached to the application which will be filed in numerical order. These are listed in a rebates and cancellations book which is simply the reverse of the premium register showing the "in force" amount and the premium involved, in addition to the cash return premium and the return commission. The totals of this record for the month will be posted as follows:

Dr. Rebates

Cr. Commissions

Cr. Agent's ledger (Gross rebates, less commissions)

### Expenditures

(a) *Claims*—The accounting involved in recording the claims on the company is very simple. The cheque register should contain columns for both claims and adjustment expense so that these two items will be segregated. Claim papers, such as the company's proof of loss form, the adjuster's report, the report to the provincial fire marshal and other correspondence constitute the claim file which is used as a voucher by the auditor. However, the auditor's work on the claims does not end when he has vouched them. All claims under contracts which have been reinsured represent an item of income, and the amount to be recovered



from other companies should be closely checked to see that it is received. The total of such amounts should be charged to an account in the general ledger "Amounts due from reinsuring companies on losses paid" and receipts credited so that control is achieved. The auditor should also see that no reinsurance is overlooked. A group of the larger claims should be checked back to the applications to see that all reinsurance has been reported on the claim voucher. At the end of each fiscal period, every company is faced with the problem of setting up a reserve for unsettled and unreported claims. No definite rules can be laid down but a very close estimate can be made from the reported claims, combined with past experience on volume of claims. In practice it is found that owing to the rapidity with which claims are reported by the middle of the following month all claims pertaining to the period in question will be known. The share of the unsettled claims of reinsuring companies should be considered and treated as an asset.

(b) *Reinsurance Expense*—A considerable item of expense to any company is the cost of reinsuring itself against unduly large losses. As mentioned previously, the company usually enters into reinsurance agreements with other companies to take care of their excess risks. The auditor should inspect the reinsurance agreement and see that the company follows it and does not leave itself open to unduly heavy losses. On the issuance of new or renewal contracts for larger amounts than it is the company's policy to insure, individual certificates are made out for each risk reinsured. These are listed on a bordereaux each month and forwarded to the reinsuring company. The bordereaux to all companies when listed in a suitable record form the basis for the entry.

Dr. Reinsurance premiums

Cr. Commissions

Cr. Unpaid reinsurance premiums

Cancellations of reinsurance may be listed at the same time and combined with the ceded listing to form a net entry. Payments of premiums (net) to the reinsuring companies will be made once monthly and charged to the unpaid reinsurance premiums account, thus cancelling the liability set up. The audit of the reinsurance bordereaux will involve work as suggested in paragraph (c) under Revenues.

(c) *Taxes*—Insurance companies operating under Dominion registry are required to pay not only federal taxes, but provincial taxes in each jurisdiction in which they operate. Briefly these taxes may be outlined as follows, but for exact details reference should be made to the respective statutes.

In the majority of jurisdictions the taxes are levied as a percentage of (a) gross premiums written in that jurisdiction, less cancellations, rebates, and reinsurance premiums paid, and (b) a fire marshal's tax levied on the net fire business written in that jurisdiction.

Federal: 1% of (a);

Prince Edward Island: A flat amount of \$225.00 per annum if the head office of the company is outside the province and \$100.00 if the head office is inside the province;

Nova Scotia:  $2\frac{1}{2}\%$  of (a) with a minimum of \$100.00, and  $\frac{1}{2}\%$  of (b);

New Brunswick: 3% of (a) with a minimum of \$150.00, and  $\frac{1}{2}\%$  of (b);

Quebec: 1% of (a) with a minimum of \$250.00, and  $\frac{1}{4}\%$  of (b);

Ontario:  $1\frac{2}{3}\%$  of (a), and  $\frac{1}{3}\%$  of (b);

Manitoba: 3% of (a), and  $\frac{1}{3}\%$  of (b);

Saskatchewan: Graduated scale of 1% to 2% on (a) plus 50% of the tax with a minimum of \$100.00 for companies whose capital does not exceed \$100,000.00, otherwise a minimum of \$175.00, and  $\frac{1}{3}\%$  of (b);

Alberta: 2% plus 10% of tax on (a), and  $\frac{1}{3}\%$  of (b);

British Columbia:  $2\frac{1}{4}\%$  on (a), and  $\frac{1}{3}\%$  on (b).

In addition to the above, there are levied provincial license fees varying from \$200.00 to \$600.00. From the above it may be seen why it is necessary to keep subsidiary records classifying each policy between jurisdictions.

### Returns

According to section 65 of the Canadian and British Insurance Companies Act, not later than March 1st in each year, all companies registered thereunder must file a statement of affairs as of the 31st day of December, in such form as may be determined by the Minister of Finance. It would

serve no purpose to list in detail the items contained in the report prescribed but brief comment is made here on a few of them.

(a) *Real Estate*—The item of real estate may be divided into two groups, the first being that of real estate held for the company's own use. Treatment of this item seems to vary widely and to the auditor accustomed to involved depreciation schedules and income tax regulations, provides a refreshing respite. The return simply calls for real estate to be valued at book value and section 71 of the Act makes provision for companies that overvalue their holdings. As a result, although some companies may follow a cost less depreciation basis, a great many reduce the value of their real estate holdings through surplus to a nominal figure much below its true value.

The other group consisting of real estate acquired through foreclosure of mortgages and held for sale is usually carried at cost, unless of course such figure is in excess of any possible recovery, in which case a reserve should be set up.

(b) *Investments*—Owing to the fact that all insurance companies have on hand at all times surplus funds, a portion of which is in the nature of a trust, consisting of unearned premiums and reserves for the protection of policyholders, their investment policy is necessarily restricted by statute. Section 60 of the federal Act specifies in what securities insurance companies may invest their funds, and should be very familiar to the auditor. Unauthorized securities are not allowed as an asset in the balance sheet. For full details the above mentioned section of the Act should be consulted.

In view of the large volume of investments held by all insurance companies and the fact that they are for the most part held till maturity, it is customary, and from an accounting standpoint necessary, to amortize the values at which they are carried on the books. Each new investment will be represented by a card or page in the investment ledger, and amortization tables should be made up or secured from the vendor. It is here suggested that the most practical treatment of the amortization table showing the division of each interest receipt between interest and principal, is to enter it immediately on the ledger card or page for

# THE ACCOUNTS AND AUDIT OF A FIRE INSURANCE COMPANY

the life of the security. Then as each payment of interest is received through the cash book, the credit to interest and the debit or credit to investment account can be determined by reference to the above mentioned ledger sheet. The increasing or decreasing book values of the investment are also listed on the same line, so that the posting of the investment ledger simply entails the entry of a cash book folio. To illustrate:

(1) Interest Due	(2) Amount	Cash Book Folio	(3) Interest	(4) Principal	(5) Book Value	(6) Par Value
					\$10,500	\$10,000
Feb. 1st, 1938	\$500	2	\$400	\$100	10,400	
Feb. 1st, 1939	500	5	395	105	10,295	

Columns (3), (4), and (5) may be written up at the time of purchase. The above treatment has also an advantage to the auditor. Once it is seen that the amortization table is properly entered on the investment ledger, verification of the correct amortization figures simply involves calling the posting from the cash book to that ledger.

The valuation of investments by insurance companies is prescribed by the Act in section 67 where it states that in the annual statement required to be deposited with the department of insurance the bonds, debentures, and stocks shall be valued at market values but, when in the opinion of the Minister market values are depressed, he may authorize the use of values in excess of said market values. It should be noted that the statement calls for book values of bonds, debentures, and stocks, but from the total gross assets is deducted or added an amount sufficient to bring those values to market values. In the company's own statement for publication it is not suggested that this practice be followed. Where book values are below market values, the securities should be shown at book value with a notation of the market value. Where book values are above market values, investment reserves sufficient to reduce the book value to market value should be established and be deducted from the asset to which the reserve pertains. That is to say, the accepted accounting practice should be followed, e.g.

Bonds and debentures at book value (Market value		
\$11,000) .....	\$12,000.00	
Less Investment reserve...	1,000.00	\$11,000.00

(c) *Agent's Balances*—Although the Act governing companies operating under Dominion registry does not so state, the auditor should confirm all balances due from agents by sending out the usual form of verification, asking to be advised of any differences. For balance sheet purposes, balances owing for a period in excess of ninety days are an unadmitted asset.

(d) *Unadmitted Assets*—Both the federal and provincial departments of insurance do not allow certain types of assets to be included in arriving at the surplus of the company. This type includes office furniture and fixtures, plans and maps, agents balances over ninety days, unauthorized investments and other sundry assets, which must be included in the unadmitted assets section of the balance sheet.

(e) *Reserve of Unearned Premiums*—At the termination of each accounting period, every fire insurance company has a liability under contracts which extend into the future. For this reason, it is necessary to calculate the reserve of unearned premiums, and in calculating this reserve all business written in any year is treated as though it had been written on July 1st. Accurate records of business written and cancellations classified as between one-, two- and three-year business must be available. For example, in calculating the reserve at 31st December 1938:

Premiums Written	Term	Unearned Portion
1938 .....	1 year	1/2
1938 .....	2 years	3/4
1938 .....	3 years	5/6
1937 .....	1 year	Nil
1937 .....	2 years	1/4
1937 .....	3 years	1/2

Where the total unearned premiums have been determined, the Act states that 80% of this figure shall be the reserve held. The 20% remaining is considered to be the company's commission, should it be necessary to reinsure all the outstanding contracts. In verifying the above calculation, the auditor must accept the unaudited subsidiary records of the company but by reference to the unearned premiums as they appeared in the calculation of a year previous, and by tying up the figures of new business and cancellations with the general ledger accounts, he can satisfy himself as to

their accuracy. If desired, greater accuracy may be had by calculating on a monthly basis.

### **The Auditor's Certificate**

For companies operating under Ontario registry, the auditor's certificate is specified by section 318(a) of the Ontario Companies Act. However, for companies operating under Dominion registry, no particular form of certificate is required by statute, but reference is usually made to the fact that the calculation of the reserve of unearned premiums is in accord with the provisions of the Insurance Act.

In conclusion, two interesting and unusual sections of the Act deserve comment. Section 99 provides that every company must at all times maintain assets allowable under the Act to a value of at least 15% in excess of the unearned premium upon all its outstanding unmatured policies calculated *pro rata* for the time unexpired, together with the amount of matured claims and all its other liabilities of every kind. It should be noted that the Act states unearned premiums and not the 80% reserve figure, and that in calculating the assets the amount of investments in the shares of any other company transacting the business of insurance are excluded. The penalty for non compliance is cancellation of the company's certificate of registry at the discretion of the Treasury Board. It is also interesting to note that in addition to the usual company provision that no dividends shall be paid which will impair the capital, dividends shall not be declared which will reduce the assets below the above mentioned 15% or while the assets are below that figure.

Section 101 of the Act defines surplus as the excess of assets over the paid-up capital and liabilities and provides that until the surplus equals the liability in respect of all outstanding unmatured policies not reinsured, the company shall at the end of each year appropriate to surplus at least 25% of the profits of that year.

If the above article has thrown light, no matter how dimly, on some of the unusual features encountered in the audit of a fire insurance company, the writer feels that his purpose has been achieved.

**A FEW REMARKS ON BALANCE SHEETS  
AND PROFIT AND LOSS ACCOUNTS\***

**By Russell Kettle, F.C.A.,  
London, England**

**W**HAT a difference there is between listening to a speaker who expresses himself clearly and in logical sequence and to one who roams around his subject without any regard whatever for the order or method of his remarks. Both may be knowledgeable. But whereas one can lead his audience step by step to understand the facts he narrates and the conclusions to be drawn from them, the other only succeeds in giving a confused and often misleading idea of what he intends to convey.

The accounts submitted to shareholders, often with only an attenuated report of the directors, constitute the board's annual financial review for the information of their constituents, and the only means by which a large number of shareholders unable to attend the general meeting are able to follow the fortunes of their company. In spite of the improvement which has taken place in recent years in the form and substance of annual accounts, boards of directors can still be divided into the two classes of speakers to whom I have referred. I want you to look at the two specimen annual accounts in your hands. Both purport to represent the same financial position and results—the one (Appendix A) drawn up without any regard for clarity and order and the other (Appendix B) prepared to present an intelligible and easily understandable state of affairs. The directors who sign the first balance sheet—Messrs. U. N. Tidy and N. O. Changes—appear to possess the demerits of their names: to them change appears to be abhorrent and they seem to want to escape criticism by confusing the minds of the shareholders. However, two recently appointed directors—Messrs. V. Clear and U. P. T. O. Date—feel that the shareholders, whose capital they administer and to whom they are responsible, are entitled to more consideration: they have therefore insisted upon the accounts being re-

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\*A paper read before the Chartered Accountant Students' Society of London on 22nd March 1939 and reprinted from *The Accountant* (England) by courtesy of the proprietors, Messrs. Gee & Company (Publishers) Ltd.



vised, on the lines recommended by their auditors, of course, with the result shown in Appendix B.

In your examinations when preparing a balance sheet and profit and loss account to satisfy the inquiries of the examiner, you should remember that his mind, and the marks he gives, will be influenced in favour of the candidate who shows initiative and imagination in the form and grouping of the various items. A balance sheet should not be merely a mechanical summary of the balances on the books; it should be an intelligible summary to justify fully the view that it exhibits a true and correct view of the state of affairs. Of course, in practice it is not the duty of the auditor to prepare the accounts, and if they comply with the requirements of the law he cannot necessarily say they are not true and correct solely on the ground that their compilation is in unsatisfactory form or that certain desirable amplifications are omitted. But he can, and should, suggest improvements to the board.

#### **Common Deficiencies in Form of Published Accounts**

Now in the accounts which I submit in Appendix A the narrative and the way in which various classes of assets and liabilities appear are actually based upon their treatment in a selection of accounts which are published. The accounts so compiled are open to the following criticisms:—

- (a) They are cramped and printed in a cumbersome form, i.e. folded once in book form and again twice in the opposite way, necessitating concertina-like operations to disclose the accounts. You must all have heard the rustle of this performance at shareholders' meetings.
- (b) The printing is poor, the same thickness of type being used throughout, thus failing to clarify and distinguish the main headings from their subsidiary narrative.
- (c) No grouping of items is attempted, with the result that shareholders who take an intelligent interest must get out paper and pencil to ascertain the total of the fixed assets, the aggregate amount of the current assets and of the liabilities, the total accumulated reserves and the profit for the year
- (d) When dealing with figures of any size shillings and pence are of no practical importance and their

omission gives more space and adds to clarity: the intimation "adjusted to nearest £" printed in quite a number of accounts seems to me to denote an over-cautious mind. In this connection the chairman's review of the accounts is often considerably lengthened by stating *in extenso* the figures down to the last penny, e.g. "Debtors amount to five hundred and forty-one thousand nine hundred and seventy-two pounds four shillings and two pence" instead of "Debtors total five hundred and forty-two thousand pounds." Further, shareholders are not interested in technical accounting terms and the mysterious hieroglyphics "Dr.," "Cr.," "To" and "By" add nothing to their appreciation of accounts and are better left out. The headings "Capital and Liabilities" and "Property and Assets" rarely cover all the items appearing on each side of a balance sheet—for example, "Depreciation Reserve" or "Preliminary Expenses" — and seem to be redundant.

- (e) No comparative figures are given of the previous year. The intelligent shareholder is thus forced to bring with him to the meeting the previous year's accounts or to write in his own comparative figures. This is in fact usually done on the chairman's copy by the secretary. May I interpose here to say that some of the more enlightened public companies furnish as an annexe to their annual accounts certain financial data covering a period of years. I have included a *pro forma* example of such a record as Appendix C to the model accounts, which enables a shareholder not merely to see the financial position and results of his company for the current and past year, but its financial history and progress over a period. The submission of this financial record for a series of past years is compulsory in the case of certain statutory companies such as the main line railways and if and when the Companies Act is again under review, this is a matter which I think might well be considered.

#### Revised Form of Presentation

If you will now look at the revised accounts in Appendix B, you will see that these criticisms no longer apply. The

accounts are in book form, the printing is clarified, the items are suitably grouped, shillings and pence and accounting terminology are absent and comparative figures are supplied. Both accounts are built up from the same data, but with what different results. Almost the only thing unchanged is the name of the company and I am sure it will be obvious to you that even this in the accounts I submit has not the same meaning in both cases!

Perhaps we can now examine a little more closely the differences in treatment of individual items. I will first refer to what I may call the model accounts and then by inference or otherwise to corresponding items in the other accounts. Share capital authorized and issued is so arranged as to avoid duplication of the description of each class of share, the issues appear in order of priority and the fact that all consist of £1 shares is so stated once instead of five times. The avoidance of apparently trivial duplications like this is not unimportant and you will observe other like examples in the accounts before you. Next, there are gathered together all the reserves and the profit and loss account balance which the directors propose to carry forward after making transfers to reserves and providing for dividends proposed. An intermediate balance sheet total is struck at this point to show the aggregate of the capital, reserves and retained profit and loss balance which together represent the shareholders' capital and accumulations of profits invested in the business. Although dividends recommended by the directors are subject to approval by the shareholders and are not technically liabilities at the balance sheet date, the practice of providing for such dividends and showing the resulting balance of profits is now sanctioned by usage and has everything to commend it, i.e. it does show the liabilities additional to those otherwise stated which require to be met out of the assets at the date of the balance sheet and also the balance of profit proposed to be carried forward. The method of arriving at the final profit and loss balance is shown by the appropriation account and by this means deductions for transfers to reserve and dividends do not complicate the balance sheet. There is no need to repeat past history by showing, as is done in the original balance sheet, the appropriations from the profits of the previous year. Incidentally, it is difficult to appreciate why the practice still obtains of describing interim and final

dividends on ordinary shares as "Interim (or final) dividend for the half year at the rate of 8 per cent. per annum less income-tax." If paid in respect of a period of three months a rate of 16 per cent. per annum would look even more handsome. Dividends are declared and paid for, or on account of, the financial year, so why not be clear and say what both such dividends really are, namely, "Interim (or final) dividend of 4 per cent. less income-tax." In regard to reserves, it is no doubt elementary to you to know that they should not be described as funds. They may be fund accounts if represented by specific liquid assets, which is rarely so, but otherwise they should be called reserves or reserve accounts. You will no doubt observe, when comparing the two balance sheets, the added advantage of last year's comparative figures in that they not only afford comparison, but avoid the necessity of narrative to show additions to certain reserves and other items, the facts being self evident when read in conjunction with the appropriation account. As you will see, the reserves include an amount for taxation. The actual liability is provided under current liabilities, the taxation reserve is free at the date of the accounts, being a wise and prudent allocation of profits on account of future liability based upon profits already earned.

#### **Treatment of Liabilities**

Next come the two issues of debenture stock grouped to show the total debenture debt. The interest rates are printed in figures and not in words; the nature of the respective security, method of repayment and final due dates are given, with a note, in the case of the second issue, of its authorized amount, thereby indicating the company's additional borrowing powers. Not infrequently, however, the terms of redemption are too complicated to be dealt with in the balance sheet.

Last on the liabilities side there is a summary of liabilities (including proposed dividends) showing the total current indebtedness of the company. The extent to which liabilities should be grouped is a matter upon which opinions may differ except that debenture stock interest, being secured, and amounts due to subsidiary companies must, as you know, be stated separately. In this connection may I interpose to say that if, as frequently occurs, subsidiary companies lodge their surplus funds with their parent the

description "Deposits by subsidiary companies" conveys more than "Amounts due to subsidiary companies." The choice of appropriate words may put an entirely different complexion on the real nature of transactions. The showing of small items of liabilities (and also of assets), such as unclaimed dividends, seems to me to indicate a lack of the sense of proportion; their separate disclosure is of no importance or materiality to shareholders who look for substantial presentation. Straining at the gnat and swallowing the camel is an apt expression very often in relation to published accounts. The use of the term "Credit Balances" (and also "Debit Balances"), which one still occasionally finds, is meaningless and should be avoided as should also the word "Sundry."

#### **Treatment of Assets**

Will you now look at the assets side of the balance sheet. First we have the fixed tangible assets relegating goodwill—which may quite well justify its value—to the foot of the accounts. There is no real objection to it taking first place, but in this case the architecture of the figures is easier if it appears last; otherwise another column would be essential to retain the grouping and to show separate totals of each group.

The fixed tangible assets are shown at cost or valuation with accumulated depreciation as a deduction as opposed to net figures and both figures would, of course, be adjusted in respect of assets no longer in use. This method of statement appears to me to be sufficiently informative. It could, of course, be expanded in columnar form or by additions and deductions horizontally, requiring considerably more space, to show the cost to the date of the last balance sheet, additions, less sales, since, and by way of deduction, the accumulated depreciation to the end of the previous year and the current year's provision. The comparative figures show, however, the net increases or decreases in the fixed assets during the year and it should not be forgotten that the overburdening of accounts with detail is apt to defeat its object. Shareholders can become bewildered with a mass of information as well as by paucity of it. You will note a different treatment regarding the balance of £10,000 payable on a recently purchased property. I prefer to bring it into the books rather than deal with the commitment by

way of note; if the amount were substantial it would, if merely noted, materially affect the view of liquidity gained by deducting the current liabilities from the current assets.

### Statement of Interests in Subsidiary Companies

Interests in subsidiary companies consisting of share capital and advances form a separate group of a hybrid nature not being easily classified either as fixed or current assets. It is obviously incorrect to give the impression, as is done in the original balance sheet, that shares in subsidiary companies are marketable, by grouping them with general investments. Further, the advances are of a different nature from debts and other amounts owing, the liquidation of which may be looked for in the ordinary course of business: they are in the nature of capital loaned to the subsidiary companies. Frequently, such advances are represented by capital expenditure in the accounts of the subsidiary companies and in that case it is desirable that that fact should be indicated by describing the item "Advances mainly represented by capital expenditure." However, in our balance sheet you will see that for the information of the shareholders a note is added giving a brief indication of the amount of the fixed and net current assets representing the share investment and showing that the net assets of the subsidiary companies figure in their balance sheets at £332,315 against the sum of £292,105 at which the shares are stated in the balance sheet of the parent company. It is also apparent from the statement that the advances are covered by current assets.

The remaining items, consisting of current assets, have been rearranged in a group. The expression "after making provision for bad and doubtful debts" still survives: Bad debts should be written off. The various items of cash need not be detailed.

### Financial Position and Trend Should be Made Easily Ascertainable

Looking now at our balance sheet as a whole, we can see at a glance, which is impossible in the original account:—

(a) The Share Capital .....	£2,300,000
(b) The aggregate Reserves and retained Profits ....	635,403
a total of .....	<u>£2,935,403</u>

# A FEW REMARKS ON BALANCE SHEETS

and the general nature and amount of the assets in defined categories which, after deducting the current and funded liabilities, represent the Share Capital and Reserves, namely:—

	£	£
(c) Fixed Assets .....	2,197,902	
(d) Interest in Subsidiary Companies .....	417,115	
(e) Current Assets .....	£1,542,936	
<i>Less—</i>		
(f) Current Liabilities .....	472,550	
resulting in net current assets of .....	1,070,386	
giving total tangible assets less current liabilities of .....		3,685,403
<i>Deducting—</i>		
(g) Debenture Stocks .....	1,750,000	
there remain net tangible assets of .....	1,935,403	
<i>Adding—</i>		
(h) Goodwill .....	1,000,000	
we arrive at the net assets including Goodwill of .....		<u>£2,935,403</u>

Preference Shareholders can thus appreciate that their capital of £800,000 is covered nearly 2½ times by the net tangible assets, whilst Ordinary Shareholders will recognize that their capital of £1,500,000 is represented as to about 75 per cent. by net tangible assets and the balance by Goodwill.

We can also see from the Balance Sheet the extent to which the fixed assets have been depreciated to date, the financial position of the subsidiary companies as a whole, their profits not brought into account, and the market or computed value of the general investments. The comparative figures of the previous year themselves explain much that has happened in the policy of the board and the trend of the company's trading and other activities.

You may possibly have noticed a recent innovation adopted by a few companies which, instead of submitting their balance sheets in the ordinary form of a double-sided document, set out the various items in the form of a continuous narrative or review on the lines I have just indicated when summarizing our balance sheet, the details of the various groups of items being set out to make up the total of each group. The profit and loss account is dealt with in a similar manner. There are many cases, however,



where such a form of account may be neither practicable nor desirable in that it would be less intelligible than the ordinary type of balance sheet and profit and loss account owing to its length and cumbersome appearance.

#### **Contrasts in Form of Presentation of Profit and Loss Accounts**

We will now leave the balance sheet and consider the profit and loss account, about which there is usually more criticism on the part of shareholders on the ground of its abbreviated form and consequent paucity of information. In the revised form it is, as you will see, divided into two sections, first the account of the year's trading and secondly a statement of the available profits, including the carry forward from the previous year, and their allocation to reserves and by way of dividends. Apart from the requirements in the Companies Act for disclosure of directors' remuneration and the statement under Section 126 as to how the profits and losses of subsidiary companies have been dealt with, the extent of the information to be given is entirely in the discretion of the board. Even strict compliance with the two requirements I have mentioned may be farcical, quite uninformative and misleading—in fact a skilful non-disclosure. I think you will agree that the original account is untidy and confused; it does not show the profit for the year and the items on the debit side are partly in the nature of charges and partly dividend appropriations. Frequently, although not in this example, the profit for the year is made more difficult to ascertain by bringing into the account the balance from the previous year. You will note the fact stated in the narrative that the profit is arrived at after providing for expenses of management and sometimes this is expanded to "all expenses of working and management:" there could hardly be a profit before deducting such obvious expenses and it seems unnecessary to state this fact either in the profit and loss account or in profit certificates for prospectuses. The directors' proposals for final dividends will appear in their report and not be reflected in the accounts. The statement under Section 126 is almost valueless when unsupported by figures in the accounts and the wording used in the disclosure of directors' remuneration gives the impression that the figure given is the whole of the remuneration of the directors and not merely that part required to be stated.

### **Extent of Information to be Given in Profit and Loss Accounts**

The extent to which directors should give detailed information of trading is a very debatable point. There are frequently very good arguments for reticence in disclosure of such details. But this should not prevent the submission of a reasonable account or the disclosure of abnormal items which materially affect the year by year results otherwise prepared upon a consistent basis. There are two items which may fluctuate considerably from year to year, viz. taxation and depreciation, and it seems reasonable that the charges under these heads should be shown. Then we come to the thorny question of treatment of profits and losses of subsidiary companies. Here I prefer such results to be incorporated in the accounts of the parent company (and if desired form part of the item of profit on trading), but there may be very good reasons for not doing so. The directors may think it unwise to take credit for the entire results of subsidiary companies in view of their state of illiquidity or for other reasons. But it should be borne in mind that the undisclosed extent to which subsidiary companies' profits are not distributed may have the effect of creating quite an erroneous impression of the year's profit of the undertaking as a whole and distort the trend of profits year by year. The subject is admittedly difficult in practice, but when replying to examination questions you can be an idealist. In the accounts I show by way of note the figures of subsidiary companies' profits which are comparable with the net profits taken credit for and in the balance sheet, also by way of note under the profit and loss account balance, the amount of undistributed profits of subsidiary companies carried forward. This information, with the summary of the financial position of subsidiaries in the balance sheet is fairly comprehensive. If on the other hand there were good reasons for not disclosing the results of subsidiary companies, a note of the net amount of their profits or losses for the year not dealt with in the parent company's accounts would meet the criticism I have made. But the statement under Section 126 in the original accounts that the profits have been taken credit for "only" to the extent of dividends implies substantial undrawn profits which is far from correct when one can see, from the revised accounts, that £30,237 is taken credit for out of

£33,616. The disparity between the combined profits of a parent and its subsidiary companies and the profits of a parent company including only such results of subsidiary companies as it incorporates in its accounts is sometimes apparent by comparing in a prospectus the two reports of the accountants giving, firstly, the group profits and, secondly, to meet statutory requirements, the profits as shown by the parent company's accounts.

**Necessity for Adequate Information to Form Proper  
Conclusions as to Year's Results and Trend**

Now we come to the conclusions which can be drawn from the original and revised profit and loss account. The year's profit in each case is the same. But the original account fails to disclose facts which have an important bearing on the final result and the trend of the business as evidenced by a perusal of the revised accounts. Although the profit of the previous year, namely, £155,177, was only slightly less than the profit of £161,102 for 1937, the results do not in fact justify the general impression which the original accounts give, that normal trading has been well maintained. On the contrary, as shown by the revised accounts, the profit on trading after providing for directors' fees and depreciation was actually less by about £42,000 and whilst dividends, less loss, from subsidiary companies were nearly the same, the results of subsidiary companies revealed a decline of about £34,000 so that the results of trading were actually about £76,000 less favourable than those of the previous year. Further, to the extent of about £48,000 there is a somewhat fortuitous profit on sale of investments—merely indicated in the narrative in the original accounts without disclosure of amount—which goes to offset the decline in trading profits. You will, therefore, appreciate the importance of a consistent basis of disclosure. Consistency of treatment must, however, be tempered by a sense of proportion: for example, a profit on realization of investments of £100 would be unimportant in relation to the figures as a whole.

The shareholders, having before them the profit and loss account in the revised form, can now consider the year's results in relation to their investment, i.e., preference shareholders will see that their net dividend (£36,000) was covered over four times and the ordinary shareholders that

their net dividend of £90,000 compared with profits available of £125,000, excluding the amount of £25,000 allocated to debenture redemption—which might, but has not been dealt with to reduce *pro tanto* the normal charge for depreciation—and the small undistributed profits of subsidiary companies. Looked at from the point of view of the company as a whole the profit for the year of £236,000 (that is £161,000 shown by the profit and loss account plus income-tax £50,000 and debenture redemption £25,000, ignoring the small undistributed profit of subsidiary companies) represents about 8 per cent. on the total share capital and reserves of £2,935,000. These calculations, however, are based upon the available profit for the year, which includes a large non-recurring surplus of £48,000 from sale of securities approaching in amount one-third of the balance of profits: due weight should, of course, be given by shareholders to this important feature when considering the question of security of income. The comparative figures of the previous year, due regard being paid to exceptional items, can be contrasted in a similar way and if financial information for a series of years is given in the form of Appendix C, a very useful view can be formed of the capital and income merits of the two classes of share capital.

I have, of course, compiled my examples of accounts to emphasize the points I wished to make. Accountants have not all the same ideas as to grouping and tabulation, but provided the main features I have outlined are brought out clearly, the substance of my general criticism will be met. Refusal on the part of a board to adopt the auditors' suggestions of clarifying and amplifying the accounts does not in itself justify a qualified report if no questions of principle are at stake, bearing in mind in this connection both a sense of proportion and a proper interpretation of the requirements of the law, even if such interpretation falls short of what may be considered by auditors or shareholders to be desirable.

**Limitations of Accounts: Rights of Individual Shareholders to Further Information or Responsibility of Directors to Shareholders as a Whole**

In conclusion I should just like to say this. It is not in practice always so easy to deal with these problems as it is in examinations when the academic accountancy ideal can

be successfully followed. The considered views and opinions of a responsible board appointed by the shareholders to carry on the business must be taken into account and due weight must be given to them. Accounting is the handmaid of business and not its master and not least amongst the qualifications of an auditor is his ability to reconcile reasonable business considerations with proper accounting requirements in the interests of the shareholders as a body. Whilst many criticisms on the part of shareholders are justified, and it is difficult on occasions to appreciate why directors adopt what appears to be undue secrecy on matters on which shareholders are reasonably entitled to have information in the accounts, it should also be remembered that the necessarily restricted scope of balance sheets and profit and loss accounts does not permit of disclosure of more than a summary of the transactions of the year. In other words the objective of the published accounts is to provide within short compass effective means of enabling the shareholders clearly to assess and thus form an opinion upon the financial position and results and not to satisfy each and every inquiry on the part of individual members. The extent to which such inquiries should be satisfied at the annual general meeting is the responsibility of the board who must judge whether and to what extent it is in the interests of the shareholders as a body that supplementary information should be given at the instance of one shareholder not merely to the members present but as a consequence to the world at large. The bogey of the competitor as an excuse for withholding information is on occasions ridden hard: on the other hand critics are sometimes apt to forget that the owners of a so-called public company are a group of private individuals the internal working and details of whose joint business are entitled to the same protection and freedom from publicity as is enjoyed by a private firm. Limitation of personal liability is not the only limitation of rights and responsibilities of individual shareholders inherent in an investment in a public company.

I hope you have found interesting and helpful the suggestions I have made for improving balance sheets and profit and loss accounts.

STORY TELLER & CO. LTD.

Dr.	PROFIT AND LOSS ACCOUNT FOR THE YEAR TO 31st DECEMBER 1937				Cr.	
	£	s	d	£	s	d
To Directors' Fees .....	2,000	0	0	By Net Profit after crediting interest, dividends and surplus on realization of investments and after providing for expenses of management, bad and doubtful debts, taxation, depreciation and contingencies .....	257,164	4 9
" Interest on First Mortgage Debenture Stock to 31st December 1937, less Income Tax .....	29,062	10	0			
" Interest on Second Debenture Stock to 31st December 1937, less Income Tax .....	45,000	0	0			
" First Mortgage Debenture Stock Sinking Fund .....	25,000	0	0			
" Dividend on Preference Shares for half year to 30th June 1937, less Income Tax .....	18,000	0	0			
" Interim Ordinary Share Dividend for half year to 30th June 1937, at the rate of 6 per cent. per annum less Income Tax .....	33,750	0	0			
" Balance per Balance Sheet .....	104,351	14	9			
	£257,164	4	9		£257,164	4 9

# STATEMENTS IN ACCORDANCE WITH SECTIONS 126 AND 128 OF THE COMPANIES ACT, 1929

The profits of Subsidiary companies have been included in the Profit and Loss Account of this company only to the extent to which they have been declared as dividends and a loss incurred by a subsidiary company has been provided for.

**Directors' remuneration, including amounts received by directors from subsidiary companies, amounted to £3,750.**

U. N. TIDY,  
N. O. CHANGES,

Dr.		BALANCE SHEET—			
<i>Capital and Liabilities</i>		£	s	d	£ s d
To Share Capital Authorized—					
2,000,000 Ord. Shares of £1 each		2,000,000	0	0	
1,000,000 Six per cent. Cum. Pref. Shares of £1 each ....		1,000,000	0	0	
500,000 Shares of £1 each ....		500,000	0	0	
		<u>£3,500,000</u>	<u>0</u>	<u>0</u>	
" Share Capital Issued—					
1,500,000 Ord. Shares of £1 each, fully paid .....		1,500,000	0	0	
" 800,000 Six per cent. Cum. Pref. Share of £1 each, fully paid		800,000	0	0	
					2,300,000 0 0
" Five per cent. First Mortgage Debenture Stock .....					750,000 0 0
" Six per cent. Second Debenture Stock (secured) .....					1,000,000 0 0
" Interest accrued on First Mortgage Debenture Stock and Second Debenture Stock .....					18,281 5 0
" Reserve Fund as at 31st December 1936 .....		180,000	0	0	
Add—Transferred from Profit and Loss Account .....		20,000	0	0	
					200,000 0 0
" Debenture Sinking Fund .....					50,000 0 0
" Dividend Equalization Fund ....					75,000 0 0
" Development Fund .....					30,873 6 9
" Sundry Creditors and Credit Balances including accrued charges and provision for Taxation and Contingencies .....					517,874 11 11
" Bills Payable .....					10,000 0 0
" Amount due to Subsidiary Company .....					7,931 2 2
" Unclaimed Dividends .....					212 13 6
" Profit and Loss Account—					
Brought forward from last account .....		166,428	6	3	
Less—Transfer to Reserve Fund .....		£20,000			
Pref. Dividend for half year to 31st December 1936 (less Income Tax) .....		18,000			
Final dividend on Ordinary Shares for half year to 31st December 1936, at the rate of 8% per annum (less Income Tax) .....		45,000			
		<u>83,000</u>	<u>0</u>	<u>0</u>	
		83,428	6	3	
Add—Balance for year per annexed account .....		104,351	14	9	
					187,780 1 0
					<u>£5,147,953 0 4</u>

## AUDITORS' REPORT TO

In accordance with the provisions of Section 134 of the Companies and explanations we have required. In our opinion the balance sheet so as to exhibit a true and correct view of the state of the company's given to us and as shown by the books of the company. The deeds been verified by us.

2 High Road, London.  
30th March 1938.



A (Continued.)

31ST DECEMBER 1937

31st DECEMBER 1937	Cr.	
<i>Property and Assets</i>	£	s d
By Goodwill at Cost .....	1,000,000	0 0
" Freehold and Leasehold Land and Buildings at valuation in 1921 plus additions at cost, less sales and less amount written off and depreciation .....	1,372,102	2 4
<i>Note.</i> —There is a liability for balance of purchase price (£10,000) of a property recently acquired.		
" Plant and Machinery at Cost plus Additions, less Sales, and less Depreciation .....	814,800	1 3
" Furniture and Fittings at Cost, less Depreciation .....	1,000	0 0
" Investments—		
Subsidiary Companies at Cost		
less amount written off .....	292,105	1 4
General, at or under Cost .....	109,333	2 1
	401,438	3 5
" Stock in Trade and Stores as valued by the Management .....	762,486	8 2
" Sundry Debtors and Debit Balances including payments in advance, after making provision for Bad and Doubtful Debts .....	541,972	4 2
" Bills Receivable .....	14,000	0 0
" Loan .....	1,300	0 0
" Amount due by Subsidiary Companies .....	125,010	0 3
" Deposit Account at Bank .....	50,000	0 0
" Cash at Banks .....	63,417	4 1
" Cash in Hand .....	214	3 2
" Midland Bank, Ltd.—Dividend Account .....	212	13 6

U. N. TIDY, }  
N. O. CHANGES, } *Directors.*

£5,147,953 0 4

#### THE SHAREHOLDERS

Act, 1929, we beg to report that we have obtained all the information as above set forth, dated 31st December 1937, is properly drawn up affairs according to the best of our information and the explanations of the freehold and leasehold properties and the other securities have

WATCH, DOGG & Co., }  
*Chartered Accountants, } Auditors.*

APPENDIX  
STORY TELLER  
BALANCE SHEET AT

	Authorized £	Issued £	£	1936 £
<b>CAPITAL (in £1 Shares)—</b>				
6% Cumulative Preference Shares .....	1,000,000	800,000		
Ordinary Shares .....	2,000,000	1,500,000		
Unclassified Shares .....	500,000	—		
	<u>£3,500,000</u>	—	2,300,000	2,300,000
<b>RESERVES—</b>				
General .....		220,000		200,000
First Mortgage Debenture Stock Redemption .....		50,000		25,000
Contingencies .....		85,000		80,000
Dividend Equalization .....		75,000		75,000
Development .....		30,873		36,641
Taxation—on account of future liability .....		81,000		85,000
		<u>541,873</u>		<u>501,641</u>
<b>PROFIT AND LOSS ACCOUNT—</b>				
Balance proposed to be carried forward per Appropriation Account .....		93,530		83,428
(Undistributed Profits of Subsidiary Companies amount to £40,210 (£37,731).)			635,403	585,069
			<u>2,935,403</u>	<u>2,885,069</u>
<b>5% FIRST MORTGAGE DEBENTURE STOCK, 1967—</b>				
Secured by a first charge upon the fixed assets and a floating charge upon other assets: repayable at par by annual drawings .....		750,000		775,000
<b>6% SECOND DEBENTURE STOCK, 1990—</b>				
Part of an authorized issue of £1,250,000 secured by a second charge upon the assets: repayable at 102% .....		1,000,000		1,000,000
			1,750,000	<u>1,775,000</u>
<b>CURRENT LIABILITIES—</b>				
Interest accrued on Debenture Stocks (less tax) .....	18,281			18,516
Balance of Purchase Price of Property Trade and other creditors and Bills Payable, including provision for accrued charges .....	297,960			354,512
Taxation accrued to date .....	64,128			29,720
Amount due to Subsidiary Company (less dividend since declared) .....	7,931			10,017
Accrued Dividend on Preference Shares and proposed final dividend on Ordinary Shares (less tax) .....	74,250			63,000
			472,550	<u>475,765</u>
			<u>£5,157,953</u>	<u>£5,135,834</u>

**REPORT OF THE AUDITORS TO THE**

We have examined the above Balance Sheet dated 31st December required. In our opinion such Balance Sheet is properly drawn up affairs according to the best of our information and the explanations

2 High Road, London.  
30th March 1938.

B.  
 & CO. LTD.  
 31st DECEMBER 1937

	£	£	1936 £
<b>FREEHOLD AND LEASEHOLD LAND AND BUILDINGS</b>			
at valuation in 1921 plus additions at cost .....	1,742,804		
<i>Less</i> —Depreciation and special amount written off in 1929 .....	360,702		
		1,382,102	1,313,071
<b>PLANT AND MACHINERY at Cost ...</b>	1,378,002		
<i>Less</i> —Depreciation .....	563,202		
		814,800	701,192
<b>FURNITURE AND FITTINGS at Cost</b>	15,709		
<i>Less</i> —Depreciation .....	14,709		
		1,000	1,000
		2,197,902	2,015,263
<b>SUBSIDIARY COMPANIES (WHOLLY OWNED)—</b>			
Cost of Share Capital, less provision for losses .....	*292,105		301,868
Advances, including dividend since de- clared .....	125,010		110,721
		417,115	412,589
<i>*The Balance Sheets of Subsidiary Com- panies show:—</i>			
	£	£	
<i>Fixed Tangible Assets</i>		310,304	
<i>Current Assets</i> .....	184,716		
<i>Current Liabilities in- cluding advances from Parent Company, and dividend declared ...</i>	162,705		
	22,011		
<b>Net Assets ....</b>	<b>£332,315</b>		
<b>STOCK AND STORES as valued by the Management .....</b>	762,487		793,017
<b>DEBTORS, LESS PROVISION FOR DOUBTFUL DEBTS .....</b>	536,061		496,777
<b>PAYMENTS IN ADVANCE .....</b>	21,211		19,764
<b>INVESTMENTS at Cost less Amounts written off .....</b>	109,333		251,720
(Market or computed value—£121,672 (£302,015).)			
<b>BALANCES AT BANKERS AND CASH IN HAND .....</b>	113,844		146,704
		1,542,936	1,707,982
		4,157,953	4,135,834
		1,000,000	1,000,000
<b>GOODWILL at Cost .....</b>		£5,157,953	£5,135,834
V. CLEAR, } U. P. T. O. DATE, } <i>Directors.</i>			

**MEMBERS OF STORY TELLER & CO., LTD.**

1937, and have obtained all the information and explanation we have  
 so as to exhibit a true and correct view of the state of the company's  
 given to us and as shown by the books of the company.

WATCH, DOGG & Co., }  
*Chartered Accountants,* } *Auditors.*

## APPENDIX

## STORY TELLER

## PROFIT AND LOSS ACCOUNT FOR

	£	£	1936 £
<b>DEBENTURE SERVICE—</b>			
Interest (gross) on:			
5% First Mortgage Debenture Stock .....	33,750		40,000
6% Second Debenture Stock .....	60,000		60,000
	<u>98,750</u>		<u>100,000</u>
Redemption—amount required to be set aside out of profits in respect of First Mortgage Debenture Stock .....	25,000		25,000
		123,750	125,000
<b>RESERVE FOR TAXATION ON CURRENT YEAR'S PROFITS—</b>			
Income Tax .....	50,000		60,000
National Defence Contribution (9 months) ..	7,000		—
	<u>57,000</u>		
<b>BALANCE, BEING PROFIT FOR YEAR car- ried to Appropriation Account below ..</b>		161,102	155,177

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£341,852 £340,177

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## PROFIT AND LOSS

	£	£	1936 £
<b>AMOUNTS ALLOCATED TO RESERVES—</b>			
General .....	20,000		20,000
Contingencies .....	5,000		
		25,000	
<b>DIVIDENDS (LESS TAX) PAID AND PRO- POSED ON—</b>			
6% Preference Shares .....	36,000		36,000
Ordinary Shares—			
3% Interim paid .....	£33,750		3%
5% Final proposed .....	56,250		4%
	<u>90,000</u>		<u>78,750</u>
		126,000	114,750
<b>BALANCE PROPOSED TO BE CARRIED FORWARD</b>			
Per Balance Sheet .....		93,530	83,428
		<u>£244,530</u>	<u>£218,178</u>

## STATEMENT IN ACCORDANCE WITH

Profits of two Subsidiary Companies are included in the above has been made for a loss incurred by the remaining Subsidiary company.

B (Continued)

& CO., LTD.

THE YEAR TO 31st DECEMBER 1937

	£	£	1936 £	£
PROFIT ON TRADING .....		350,565		391,242
Less—Directors' Fees .....	2,000		2,000	
(The total Directors' remuneration required to be stated under Section 128 of the Companies Act, 1929 is £3,750.)				
Depreciation of Buildings, Plant and Machinery .....	91,660		89,701	
	<u>93,660</u>		<u>91,701</u>	
		256,905		299,541

INCOME (GROSS) FROM SUBSIDIARY COMPANIES—

Interest on Advances .....	5,000	4,000	
Dividends .....	35,000	28,000	
	<u>40,000</u>	<u>32,000</u>	
Less—Provision for loss .....	9,763	1,576	
	<u>30,237</u>	<u>30,424</u>	

*Note.—Profits, less loss, of Subsidiary Companies before charging inter-company interest and Income Tax—*

1937	1936
£33,616	£67,155

INTEREST AND DIVIDENDS (GROSS) ON GENERAL INVESTMENTS ...	6,237	10,017
SURPLUS ON REALIZATION OF INVESTMENTS .....	48,186	—
TRANSFER FEES .....	287	195
	<u>£341,852</u>	<u>£340,177</u>

APPROPRIATION ACCOUNT

	£	1936 £
PROFIT FOR YEAR per above Account .....	161,102	155,177
BALANCE FROM PREVIOUS YEAR .....	83,428	63,001

£244,530   £218,178

SECTION 126 OF THE COMPANIES ACT, 1929

Profit and Loss Account to the extent of dividends declared. Provision Company which loss has been carried forward in the accounts of that

V. CLEAR, }  
U. P. T. O. DATE, } Directors.

THE CANADIAN CHARTERED ACCOUNTANT

APPENDIX C.

STORY TELLER & CO., LTD.

Financial Record of Past 10 Years

	1928	1929	1936	1937
Issued Capital .....				
6% Cum. Preference Shares ..				
Ordinary Shares .....				
Reserves .....				
Profit carried forward .....				
Debenture Stocks .....				
Fixed Assets .....				
Interest in Subsidiary Companies				
Current Assets less Current				
Liabilities .....				
Goodwill .....				
Trading Profit .....				
Less—Depreciation .....				
Income from Subsidiary Com-				
panies .....				
Interest and Dividends .....				
Other Income .....				
Special items (enumerated) ....				
Less—Debenture Service ...				
Taxation .....				
Profit for Year .....				
Appropriation of Profit—				
Transfer to Reserves .....				
Dividends (less tax)—				
6% Preference Shares .....				
Ordinary Shares .....				
Rate .....	%			
Increase (Decrease) in carry				
forward .....				
Add — Undistributed Profits				
(less losses) of Subsidiary				
Companies .....				

*Note.*—Any necessary explanations such as an increase in capital during the period will appear by way of note at the foot of this statement and be referenced by way of asterisk to the items concerned.

## EXTENSIONS OF AUDITING PROCEDURE\*

REPORT OF THE SPECIAL COMMITTEE ON AUDITING PROCEDURE  
AMERICAN INSTITUTE OF ACCOUNTANTS

*RESOLVED: That the council of the American Institute of Accountants hereby adopts the report of the special committee on auditing procedure dated May 9, 1939, as a statement of the best practice for the future in regard to the matters dealt with in the report. Be it*

*FURTHER RESOLVED: That the report be printed and distributed to members of the Institute and others interested.*

*Adopted May 9, 1939*

TO THE COUNCIL OF THE AMERICAN  
INSTITUTE OF ACCOUNTANTS:

Gentlemen:

Pursuant to its appointment the special committee on auditing procedure has reviewed certain phases of auditing procedures and related matters. It has taken cognizance of recent discussions regarding such procedures, both within and without the profession, and now submits its report and recommendations relating to the following:

Examination of inventories

Examination of receivables

Appointment of independent certified public accountants

Form of independent certified public accountant's report.

Your committee has limited its consideration of auditing procedures and related matters to those cases in which financial statements are accompanied by a report and opinion of an independent certified public accountant. Accordingly, the report which follows should be read in the light of this limitation.

At the outset it is pertinent to state that, since the recent disclosure of conditions existing in exceptional cases, certified public accountants have been considering possible implications which may arise therefrom in relation to their practice. The committee desires to state its opinion that auditing procedure has kept, and continues to keep, pace

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\*The editorial Committee acknowledges the kind permission of the American Institute of Accountants to publish this report in THE CANADIAN CHARTERED ACCOUNTANT.

with the growth and development of industry and that the well established custom of making test-checks of accounting records and related data and, beyond that, reliance upon the system of internal check and control after investigation of its adequacy and effectiveness, has with very few exceptions proved sufficient for its purpose. Because of public interest and discussion in the press, there is a question now before the profession as to whether its procedures shall be extended. In order to consider the question intelligently there must first be some general understanding of certain fundamentals.

In the performance of his duties as auditor the independent certified public accountant holds himself out as one who is proficient in accounting practice and auditing procedure. The function of the independent certified public accountant is to examine a concern's accounting records and supporting data, in certain matters to obtain outside confirmations, and to require and consider supplementary explanations and information from the management and employees, to the extent necessary to enable him to form an opinion as to whether or not the financial statements as submitted present fairly the position and results of periodic operations. Generally speaking, his function is limited to reporting upon situations arising out of business transactions that have taken place in the past. In no sense is he an insurer or guarantor. In offering his opinion, the independent certified public accountant assumes heavy responsibilities. He must be skilled in his professional work and must have made a reasonable examination of the accounts in order to warrant his expression of an opinion. He must state his opinion clearly and unequivocally.

Management itself has the direct responsibility for the maintenance of an adequate and effective system of accounts, for the proper recording of transactions in the books of account and for the safeguarding of the assets of a concern. It is also charged with the primary responsibility to stockholders and to creditors for the substantial accuracy and adequacy of statements of position and operations.

In order to qualify himself to carry out his function the independent certified public accountant has completed a rigorous course of professional study and training as a background to the essential practical experience he must obtain, for it is only by study, training, and practical experience



that the independent auditor acquires skill in accounting and related matters. In the ordinary course of his day-to-day practice he encounters a wide range of judgment on the part of management, varying from true objective judgment to the occasional extreme of deliberate misstatement. He is retained to examine and report upon the affairs of a concern because, through his training and experience, he has become not only skilled in accounting and auditing but has acquired the ability and habit of considering dispassionately and independently the facts recorded in books of account or otherwise disclosed by his examination and because, as a result, his opinion provides reasonable assurance that a fair and adequate presentation of pertinent information has been made in the financial statements.

The independent auditor must also exercise his best judgment in determining the scope of his examination and in deciding whether the interests of stockholders and creditors justify the time and expense involved in the extension of any particular line of inquiry. Experience shows that, with few exceptions, the personnel of business organizations is honest. The discovery of defalcations has not been a primary objective of an examination incident to the issuance of financial statements accompanied by a report and opinion of an independent certified public accountant, although such discovery has frequently resulted. In a well organized concern the principal reliance for the detection of such irregularities is placed upon the maintenance of an adequate system of accounting records with appropriate internal check and control. It is the duty of the independent auditor to satisfy himself that the system of internal check and control is adequate and sufficiently effective to justify reliance thereon. To exhaust the possibility of exposure of all cases of dishonesty or fraud, the independent auditor would have to examine in detail all transactions. This would entail a prohibitive cost to the great majority of business enterprises—a cost which would pass all bounds of reasonable expectation of benefit or safeguard therefrom, and place an undue burden on industry.

In carrying out his work the independent certified public accountant must always be on his guard against collusive fraud and be alert in detecting any sign of such collusion. However, on the basis of his examination by tests and checks, he relies upon the integrity of the client's or-

ganization unless circumstances are such as to arouse suspicion, in which case he must extend his procedures to determine whether or not such suspicions are justified.

In the judgment of this committee the independent certified public accountant should not express the opinion that financial statements present fairly the position of the company and the results of its operations, and that they conform to generally accepted accounting principles, when his exceptions are such as to negative the opinion, or when the examination has been less in scope than he considers necessary. In such circumstances, the independent certified public accountant should limit his report to a statement of his findings and if appropriate his reasons for omitting an expression of opinion.

Turning now to consideration of the specific matters referred to at the beginning of this report, it may be noted in passing that, although it has not generally been considered normal procedure, in some cases independent certified public accountants have made physical test-checks of inventory quantities and have confirmed receivables by direct communication with debtors. Such physical tests of inventory, however, have usually been undertaken as an additional procedure under arrangement with the client, while confirmation of receivables by direct communication with debtors has been undertaken where the accountant thought it an essential or desirable step in a particular case or at the request of the client.

Your committee is of the opinion that recognition should be given to the widespread demand for an extension of auditing procedures with regard to inventories and receivables. However, it should be noted that additional expense to business will be involved in the added procedures, and business concerns which do not have them undertaken must recognize the necessity of disclosure of their omission.

#### INVENTORIES

The added steps that may well be taken to give greater assurance with regard to inventory quantities will vary in different circumstances but, however extensive these may be, the training and experience of an independent certified public accountant do not qualify him as a general appraiser, valuer, or expert in materials. The public should understand that, while he can take steps to warrant the expres-

sion of his opinion as an accountant that stated quantities of merchandise are actually on hand, such procedure does not invest his opinion with a degree of authority which he does not claim for it, or impose upon him a measure of responsibility which the nature of his work does not justify.

Your committee believes that corroboration of inventory quantities by physical tests should be accepted as normal audit procedure. The manner and extent thereof will necessarily vary with the circumstances, because the independent auditor is justified in giving consideration to the effectiveness of the internal check and control as applied to book records and to the procedure of taking physical inventories.

In cases where the inventory is determined solely by means of a physical count at the end of the accounting period it will be necessary for the test-checks of quantities to be made at that time. In some cases it may be practicable and satisfactory for the independent auditor to be present at the time of taking the inventory to see that a method, carefully thought out and established, and providing adequate internal check and control, is in fact being followed. Another plan which would be satisfactory where the circumstances permitted would be for the auditor to encourage throughout the year the continuous taking and checking of parts of the inventories against stock records, or other book records, by employees independent of the stockkeeping departments, and for the auditor to examine in whole or in part the reports on these partial checks and to participate in some of them.

The general adoption of such added procedures regarding physical quantities of inventories may also necessitate procedural changes on the part of clients. So many corporations close their books upon a calendar year basis that your committee doubts whether the profession as at present organized can undertake to make physical test-checks adequately and satisfactorily on the last day of each year. Many corporations do not have adequate perpetual inventory records and greater use of them should be encouraged.

The extension of procedures regarding inventories would be greatly facilitated if each concern adopted its natural business year instead of the calendar year as its fiscal year, and introduced continuous well kept perpetual inventory records.

The proposed changes will take time to bring about, and your committee is of the opinion that in the meantime the profession may well be faced with the necessity of submitting qualified reports in those cases in which it has been impracticable to carry out the added procedures.

Taken in consideration with the foregoing discussion of audit procedures relating to inventories, your committee makes the following recommendations in respect thereof:

(a) That hereafter it should be generally recognized as normal procedure in the examination of a concern where inventories are a material factor, where the independent certified public accountant intends to report on the financial statements of the concern over his signature, and where

- (1) such inventories are physically taken at the balance-sheet date or
- (2) such inventories are physically taken at a date prior or subsequent to the balance-sheet date but within a reasonable time thereof, with adequate records supporting the interim changes in inventories,

he shall make such auditing tests and checks of the inventory accounts and records as may be feasible in corroboration of the representations of the concern relative to the inventories; also, he shall wherever practicable and reasonable make, or where the inventory taking is adequately planned and controlled observe the making of, physical tests by count, weight, or measurement, for the purpose of satisfying himself that the methods of inventory taking have been carried out effectively and for the purpose of testing the accuracy of the recording of quantities in the inventory records;

(b) That hereafter where inventories are a material factor, and a concern does not customarily take a physical inventory at the balance-sheet date but maintains well kept and controlled perpetual inventory records supported by:

- (1) a complete physical inventory at a date not coincident with the balance-sheet date, or
- (2) physical inventories of individual items from time to time so that the quantity on hand of each item is compared with the inventory record for that item at least once in each year, the independent certified public accountant shall wherever practicable and reasonable make, or, where the inventory taking is adequately planned and controlled observe the making of, physical tests

by count, weight, or measurement, at any interim date or dates selected by him for the purpose of satisfying himself as to the substantial accuracy of the perpetual inventory records so that they may be relied upon to support the inventory totals as shown on the balance sheet; and that such an examination be recognized as normal audit procedure;

(c) That hereafter, where the independent certified public accountant has not made, or observed the making of, physical tests by count, weight, or measurement, either because such tests in his opinion are not practicable or reasonable, or because he has departed from normal auditing procedure, he shall make suitable explanation or exception in reporting on the financial statements of a concern over his signature;

(d) That hereafter, in the case of inventories which in the ordinary course of business are in the hands of public warehouses or other outside custodians, direct confirmation in writing from such custodians is acceptable as a procedure in lieu of physical tests; except that where the amount involved represents a significant proportion of the current assets or of the total assets of a concern the independent certified public accountant shall make supplementary inquiries.

In making, or observing the making of, physical tests by count, weight, or measurement, the independent certified public accountant does not hold himself out as, or assume the responsibilities of, a general appraiser, valuer, or expert in materials.

#### RECEIVABLES

In regard to the question of confirming receivables by direct communication with the debtor, your committee makes the following recommendations:

(a) That hereafter, in cases where the aggregate amount of notes and accounts receivable represents a significant proportion of the current assets or of the total assets of a concern, confirmation of notes and accounts receivable by direct communication with the debtors shall be regarded as normal audit procedure in the examination of the accounts of a concern whose financial statements are accompanied by an independent certified public accountant's report; and that the method, extent, and time of obtaining such confirmations in each engagement, and whether of all

receivables or a part thereof, be determined by the independent certified public accountant as in other phases of procedure requiring the exercise of his judgment; and

(b) That hereafter, where the independent certified public accountant, for any reason, has not made such confirmation, he shall make suitable explanation or exception in his report.

APPOINTMENT OF INDEPENDENT CERTIFIED  
PUBLIC ACCOUNTANTS

Apart from the specific phases of auditing procedure which have been the subject of consideration, your committee is of the opinion that the method of appointment of the independent auditor and his status in relation to the client are subjects of great importance to stockholders and creditors.

Your committee suggests that the independent auditor should be engaged or nominated by the board of directors.

Some prominent corporations have adopted the practice of having the independent auditor elected annually by the stockholders. Other corporations have provided that the stockholders be given an opportunity to ratify the selection made by the directors.

Your committee believes that the auditor should be appointed early in each fiscal year so that he may carry out part of his work during the year.

FORM OF INDEPENDENT CERTIFIED PUBLIC  
ACCOUNTANT'S REPORT

The services which independent auditors render usually culminate in a report, which may take varying forms. In some cases a detailed report is rendered accompanied by statements and supporting schedules; in other cases the report is limited to a concise statement of the scope of the examination and the related opinion of the independent auditor concerning the accompanying financial statements of the client. For present purposes the discussion is confined to the short form of auditor's report, which is sometimes described as a certificate. The terms "report," "report and opinion," and "certificate" have been used interchangeably. As uniformity is desirable the word "report" is recommended for general use and has been adopted in the following comments.

In January, 1934, the Institute issued a pamphlet entitled "Audits of Corporate Accounts," dealing with a standard form of auditor's report. The short form of report then recommended, and since widely adopted by the profession, met a long-felt need.

Developments during the five years in which the standard form of report has been used indicate the need of revision in the interest of clarity. If the revised short form recommended herein be adopted, the independent certified public accountant should recognize that in some cases it may not be altogether appropriate. For instance, there may be cases where the auditor may prefer to alter the first sentence of the standard short form, substituting some words to the effect that the accounting records (instead of the financial statements) have been examined. Obviously, also, it would be erroneous to mention internal control if none existed. Accordingly, while the proposed form is submitted as a standard, it is not prescribed or recommended for invariable use but should be adapted to the needs of the particular case. For example, the report may be used in connection with an examination covering a period of years, in which case a modification of language would be necessary. Also, in new engagements appropriate investigation relating to prior years will have to be made to justify the use of the short-form report. However, in the interest of reasonable uniformity it is recommended that the substance of appropriate phrases in the standard form be used unless inappropriate.

The major changes recommended pertain to the description of the scope of the examination, specifically to include reference to the system of internal control. The phrase "obtained information and explanations from officers and employees of the company" has been omitted because it is inherent in all auditing procedure to obtain information and explanations from officers and employees concerning the accounts, either as supplementing information obtained from other sources or as constituting the only available information on the subject. In the latter case, the auditor must decide, in view of all the circumstances, whether he should rely upon such information without disclosure of the source. The phrase in question has led to serious misconception as to the degree of reliance on such information and explanations. The statement "but we did not make a de-



tailed audit of the transactions" has been omitted from the revised form. It will be recalled that this clause was included in the standard form of 1934, in order to make clear that the auditor's usual procedure consisted of testing and sampling rather than a detailed audit. It is believed that the business and financial public now fully understand that, in a well organized concern, the detection of irregularities is primarily a matter of internal procedure, and that testing and sampling, to determine whether such procedure is adequate in scope and effective in operation, is the usual practice of the independent auditor. The negative statement disclaiming a detailed audit may, therefore, well be omitted. There has also been excluded the phrase "based upon such examination," as it is obvious that the independent certified public accountant can express an opinion only after he has completed the work set forth in the first paragraph of the report.

The revised short form of report consists of two paragraphs. The first contains a brief statement of the scope of the examination, and the second deals with the auditor's opinion on the financial statements of the client as a result of his examination.

In considering the independent certified public accountant's opinion the reader should bear in mind one of the most important underlying concepts of financial statements, viz., that normally many of the assets of a concern are not realizable in cash but are commonly stated at their historical cost or going-concern basis as figures which are usually greater than the realizable value in forced liquidation. Again, the true profit or loss of a concern can be determined with accuracy only over its entire existence. Therefore, in any attempt to allocate to specific periods profit or loss applicable thereto, it must be recognized among other considerations that, as many transactions are not fully completed within such periods, the result as shown must contain many estimates and approximations in the endeavor to present fairly the operating results of a period.

Assuming that normal procedures have been carried out it is considered to be neither necessary nor generally desirable to describe the details of the examination in this form of report. Any such details as are given should be included in separate paragraphs of the report. For example, reference may be made to procedures which the accountant has



adopted regarding the examination of inventory quantities, and confirmation of receivables by direct communication with debtors; also, it may be pertinent to mention the fact that certain portions of the auditor's work have been carried out at different times during the course of the year. This may be indicated by inserting the words "at times" in the first paragraph of the short form of report immediately after the words "by methods."

It should be borne in mind that the financial statements, with all supplemental descriptive and explanatory data, including footnotes, are regarded as representations of the client. It is upon all these representations that the independent certified public accountant renders his opinion. If he considers explanations essential or desirable, and they have not been made in the financial statements, it will be necessary for him to make such explanations in a separate paragraph of his report.

It is desirable as a general rule that exceptions by the independent certified public accountant be included in a paragraph separate from all others in the report, and be referred to specifically in the final paragraph in which the opinion is stated. Any exception should be expressed clearly and unequivocally, as to whether it affects the scope of the work, any particular item of the financial statements, the soundness of the company's procedures (as regards either the books or the financial statements), or the consistency of accounting practices where lack of consistency calls for exception.

It is worthy of repetition that the extent of sampling and testing should be based upon the independent auditor's judgment as to the effectiveness of internal control, arrived at as the result of investigations, tests, and inquiries. Depending upon his conclusions in this respect, the independent certified public accountant should extend or may restrict the degree of detailed examination. Consequently, in some cases it may be necessary to modify or omit reference to reliance upon the system of internal control. It follows also that where a detailed examination is made no reference to internal control is necessary.

It is contemplated that, before signing a report of the short-form type suggested, the independent certified public accountant will be satisfied that his examination is in conformity with the procedures and practices outlined in "Ex-

amination of Financial Statements," a bulletin published by the American Institute of Accountants in January, 1936, or in any subsequent revision thereof.

The report should be addressed to the board of directors or the stockholders if the appointment is made by them.

The description of the financial statements in both paragraphs should, of course, conform to the titles of the accompanying statements.

In consideration of the foregoing remarks your committee recommends the following short form of report:

*Short Form of Independent Certified Public Accountant's Report*

TO THE BOARD OF DIRECTORS (OR STOCKHOLDERS) OF THE XYZ COMPANY:

We have examined the balance-sheet of the XYZ Company as of April 30, 1939, and the statements of income and surplus for the fiscal year then ended, have reviewed the system of internal control and the accounting procedures of the company, and have examined or tested accounting records of the company and other supporting evidence, by methods and to the extent we deemed appropriate.

In our opinion, the accompanying balance-sheet and related statements of income and surplus present fairly the position of the XYZ Company at April 30, 1939, and the results of its operations for the fiscal year, and conform to generally accepted accounting principles applied on a basis consistent with the preceding year.

In conclusion, your committee desires to state that it has dealt only with the more important phases of auditing procedures and related matters which are the subject of current public interest. A more extensive review of auditing procedures is in process. In the course of its deliberations your committee has conferred with representatives of the following bodies whose interest might be affected by the committee's recommendations and has endeavored to keep them informed of progress in the work:

Advisory Council of State Society Presidents  
Controllers Institute of America  
National Association of Cost Accountants  
National Association of Credit Men

National Association of Manufacturers  
New York Stock Exchange  
Robert Morris Associates  
Securities and Exchange Commission.

Samuel J. Broad, chairman of the special committee to revise the bulletin "Examination of Financial Statements by Independent Public Accountants," and Edward A. Kracke, chairman of the special committee on inventories, have participated in all meetings of the committee.

Respectfully submitted,

**SPECIAL COMMITTEE ON AUDITING PROCEDURE**

P. W. R. GLOVER, *Chairman*  
GEORGE COCHRANE  
GEORGE P. ELLIS  
STANLEY G. H. FITCH  
J. K. MATHIESON  
NORMAN L. MCLAREN  
MAURICE E. PELOUBET  
WALTER A. STAUB  
VICTOR H. STEMPP  
C. OLIVER WELLINGTON

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**LAND SETTLEMENT TO REDUCE RELIEF ROLLS**

**A**T ABOUT this time last year (May) Henry Ford, who has pioneered many developments in motor car manufacturing, but often advocated a return to some of the ways of living of a generation ago, sponsored a community farm plan under which over fifty unemployed youths were enabled to earn a reasonable daily wage for their farm work throughout the summer and at its close divide a profit made on the enterprise amounting to nearly \$100 for each boy. While conditions in this instance were almost ideal, in that the farm chosen was located on a busy highway so that much of the produce could be sold to passing motorists and capital was not lacking to provide whatever equipment was needed for the farm—and best of all a job was waiting for each of the boys at the Ford factory at the end of the season—it would seem reasonable to suppose that a farm placement plan for unemployed persons would be of some assistance in reducing relief rolls.

This idea was mentioned in only a short paragraph in the report of The National Employment Commission, published in January 1938, but the various Provinces in co-operation with Federal authorities have adopted various plans to carry it into effect.

In the western provinces a scheme has been developed whereby single men on relief may be allotted to farms and the government supplies a small amount to the farmer which he in turn pays over to the reliefee. It would seem probable that these persons might displace presently hired men and thus aggravate the problem, but this does not appear to have happened.

The Dominion-Provincial Youth Training Plan includes in its program provision for farm training, so that the younger generation may not be unprepared if an opportunity is given to them for land settlement. In Saskatchewan, for example, at the provincial university a six-weeks' short course is provided. Twice a year one hundred young Saskatchewan farmers are paid \$50 for transportation, board and books for the duration of the course. The course consists of four weeks' farm mechanics, each day consisting of three lectures and four hours of laboratory work such as carpentry, blacksmithing, tinsmithing, farm machine adjustment and repair, and engine overhaul, and two weeks of general agriculture, which includes lectures and laboratory periods on field and animal husbandry, horticulture, poultry, dairy, entomology, veterinary science and farm management.

The interest of the boys in these courses is evidenced by the fact that between five hundred and six hundred applications were received for each of the first two courses, out of which one hundred boys were selected on the basis of worthiness and need.

Lack of experience in farming has been the cause of failure in many land settlement schemes, and the Province of Ontario in embarking upon a farm placement plan intends to run no risk of failure because of this. Applicants must have previous farm experience and a proven desire to return to farm life; they must be physically fit and have employable children to assist with the farm work.

The applicant himself must find a suitable farm that can be rented within the terms offered by the government; that is, at not more than \$200 per year for three years with

## CORRESPONDENCE

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an option to purchase. Usually the applicant locates somewhere near where he has farmed before, and local conditions are known to him. Up to \$600 will also be allowed to him for stock and equipment. Necessary direct relief assistance will be continued on a limited basis.

A plan such as this is limited in scope, perhaps not more than 200 families will be affected the first year, but it will enable authorities to test the feasibility of the plan so that it may be made available to many more who have indicated they are eager to take advantage of it.

There are real cash savings under such a plan, because shelter allowance is less, fuel allowance is less and the food allowance may also be less; but one of the greatest savings through such a plan cannot be measured in dollars and cents—that is the saving of the morale and self respect of the recipient of relief by giving him work to do and taking him off the relief roll.

G. R. G. Baker.

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## CORRESPONDENCE

*(Editor's Note: There is a standing invitation to all members of our Association to contribute to the Correspondence Column of THE CANADIAN CHARTERED ACCOUNTANT. As Dr. Horace L. Brittain, who is Director and Secretary of the Citizens' Research Institute of Canada, has contributed to our pages on previous occasions, we invited him to make some observations on Public Finance, the subject of Professor Curtis' article in the May issue. We are pleased to publish this month both his letter and that of Mr. C. W. Leach.)*

The Editor,  
The Canadian Chartered Accountant.

Dear Sir:

I have read over with great interest the article by Professor Curtis on PUBLIC FINANCE in the May number of THE CANADIAN CHARTERED ACCOUNTANT and find myself in essential agreement with his position on most of the points raised.

I certainly would not write an article on Public Finance taking issue with the general position of Professor Curtis, although I might raise in this letter some queries on matters of detail.

While in Canada, as in the world in general, there have been great increases both in public expenditures and national income during the last half century and while it is true that this may not represent a serious condition, there were in Canada between the years 1926 and 1933 large increases in the percentages that taxation and expenditure formed of the national income. This was due to two factors, the increase in public expenditures (although tax collections did not increase) and the rapid decline in the national income after 1929. Even since the beginning of recovery of the national income, the percentages are still high, taxation in 1936-7 being in Canada about 21.7 and ex-

penditure, other than that on the post office, being about 25.5% of the national income. While governments naturally encounter tremendous resistance to any attempt to reduce the governmental "cost of living" to square with reduced national income, and while increased government expenditure and reduced taxation during a period of depression may often be quite justified, it is a question whether in many cases the "lag" might not have been shortened in the public interest by economies which could have been made without cutting essential services.

The chief causes of increased expenditure over fifty years are, as Professor Curtis says, increased war expenditures, increased social service expenditure (including welfare, public health and unemployment relief), increased educational expenditures and increased highway expenditures. I have not of course access to the data of Professor Curtis, but it seems to me possible that the proportions of the revenue which go to interest charges, war pensions, etc., of the last war and to the expenditures on the past war and present defence are somewhat overstated.

It is interesting also to note that during the depression, educational expenditure was the only one of the social expenditure group which declined during the depression and that even between 1926-27 and 1936-37 it increased in total only 2.34% and per capita actually decreased 11%. It is doubtful that school efficiency decreased proportionally. Apparently educational expenditures offered the line of least resistance. Possibly the "lag" would not have been so great if other governmental functions had been treated similarly.

There is another cause of the increase in public expenditure, and that is transportation deficits. These deficits varied between \$65 millions and \$100 millions between 1930-31 and 1937-38 even assuming that no element of cost is understated. It is very difficult to make the average man believe that nothing can be done without grave damage to the existing economy to reduce these annual deficits. There is evidence to indicate that the total debt properly chargeable to transportation is greater than the war debt. Annual governmental deficits at all levels of government and for all services which varied between \$100 millions and \$220 millions from 1930-31 to 1937-38 were largely added to the public debts and therefore to the current burden of taxation. To the extent that this represents waste and inefficiency, it adds to the real burden.

It seems to me that Professor Curtis underestimated the savings which could be effected by reducing waste, inefficiency and favouritism and the influence of special interests in government. Personally I believe that tremendous savings could be effected at all levels of government if there were a real will to do so. The effect of public demand as a cause of increased expenditures has been greatly overestimated. In many cases increased expenditures are due to private demand and are neither wanted nor needed by the public.

The last sentence in the paper of Professor Curtis should be graven on the heart of every legislator and public servant:

"Before acceptance, the case for each new public expenditure should be proven beyond doubt, for in general it is probably true that the best results are obtained by permitting, as far as possible, the individual citizen to spend his own income."

Yours very sincerely,

HORACE L. BRITTAIN.

## CORRESPONDENCE

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The Editor,  
The Canadian Chartered Accountant.

Montreal, 11th May 1939.

Dear Sir:

In this month's issue of THE CANADIAN CHARTERED ACCOUNTANT there appears an article on "Public Finance" written by Professor C. A. Curtis and dealing principally with the question of governmental expenditures. I realize fully the limitations placed upon anyone attempting to deal with such an extensive subject in the space of a short article, but, while I agree with and find interesting Professor Curtis' analysis of the causes of increased expenditures, I find it difficult to agree with his conclusions. To my mind, Professor Curtis is altogether too naïve, too generous, too evasive, when he dismisses with a word the whole question of party politics by saying—"It is doubtless true that in individual cases public moneys have been spent foolishly and even corruptly, but the elimination of every such case will do little to reduce the total of public expenditures." Perhaps Professor Curtis' definition of "foolishly and corruptly" is not so broad as mine, but I would include many notorious weaknesses of our politicians—refusal to face the issue (the railway problem and unemployment relief, to mention only two), playing politics (the policy of not doing anything when you can stay in office by doing nothing), patronage, bad management, and waste far and beyond mere error. It is, I agree, hard to say how much of our total expenditure goes in this way and I would hesitate to make an estimate, but the figure must be very impressive, more impressive, I fear, than Professor Curtis would have us believe.

The discussion of business principles in government administration in this article also falls somewhat short of the mark, I think. In the first place, perhaps parenthetically, successful financial operation may be the chief aim of business, but it is not the only one. There is a growing realization that a business must contribute something to the welfare of the community, must perform a public service, in order to justify its existence, and that it has a responsibility towards its employees for both selfish and unselfish reasons. Secondly, these business principles might be applied more strictly to governmental affairs with salutary effects—be honest in all things beyond the mere letter of the law, get the most for your money, subject of course to the principle of the labourer being worthy of his hire, spend what you have to spend and no more (balanced budgets), keep your word and honour your obligations at all cost, reward your servants according to merit and not otherwise. To say that these principles are not always applied in business would be but begging the question; the fact remains that they are among the better business principles.

I trust that you will not think that I have been prompted to make these remarks in an over-critical spirit. Sooner or later we must face and deal with these facts, and the members of our profession should in their own interest, as well as in that of the country, be prepared to assume their share of the burden.

Yours very truly,  
C. W. LEACH.

## GENERAL NOTES

### The King's English

The 17th May 1939 will go down in history as the memorable day on which the ruling Sovereign of the British Empire visited for the first time one of his self-governing "dominions beyond the seas." At a state luncheon held that day in Quebec City by the Government of the Dominion of Canada, King George VI gave his first address on Canadian soil. He spoke in response to the address of welcome to Their Majesties by Prime Minister Mackenzie King on behalf of the government and the Canadian people, and His Majesty's beautifully-worded message is reproduced here to be read and re-read and long to be cherished:

Mr. Prime Minister: I am deeply moved by your words of welcome to the Queen and myself on behalf of the Canadian people. I recognize that this moment is historic. It is the first time that a British King has crossed the Atlantic. I stand today on the soil of North America. Here, in the past two centuries, through loss and through gain, the British Commonwealth of Nations has been largely moulded into its present form. This is also the first visit of the sovereign to one of his oversea dominions. It is fitting that it should be to the senior dominion of the Crown. I am particularly pleased that, on the day of my arrival in Canada, I should have the pleasure of meeting not only my Ministers but all the Members of my Privy Council for Canada. You, in Canada, have already fulfilled part of the Biblical promise and obtained dominion from sea to sea. You are now engaged in fulfilling the latter part of that promise in consolidating government from the river to the ends of the earth, from the St. Lawrence to the Arctic snows. The Queen and I are looking forward, with anticipation too great for expression, to seeing all we possibly can of this vast country. Particularly do we welcome the opportunity of greeting the men and women who are its strength and stay, and of seeing something of the younger generation, so soon to become the guardians of its future.

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### Annual Meeting of 1939

As announced in the April issue, the thirty-seventh annual meeting of The Dominion Association of Chartered Accountants will be held in Saskatoon, Saskatchewan, on August 21st to 24th. Further details of the meeting will be published in our July issue.



### Our Contributors This Month

HAROLD BEVERLEY CLEARIHUE who writes on fire insurance accounts this month graduated from the faculty of Commerce and Finance of the University of Toronto in 1932 and became a member of the Institute of Chartered Accountants of Ontario in 1936. He was connected with Thorne, Mulholland and Company, chartered accountants, until 1938 when he became Secretary-Treasurer of Moneta Porcupine Mines Limited, Toronto.

RUSSELL KETTLE, whose lecture "A Few Remarks on Balance Sheets and Profit and Loss Accounts" we publish this month by courtesy of Gee & Co. (Publishers) Ltd., proprietors of *The Accountant*, England, served his articles with Messrs. Deloitte, Plender, Griffiths and Company, and was admitted to the English Institute of Chartered Accountants in 1909. He acted as personal secretary to Lord Plender from 1910 to 1918 and was admitted a partner in Deloitte, Plender, Griffiths and Company in 1919. Mr. Kettle was Chairman of the London Members' Committee of the Institute of Chartered Accountants in 1929.

### PROVINCIAL NEWS

#### MANITOBA

As a compliment to our Dominion President, the last of four business meetings of the members of The Institute of Chartered Accountants of Manitoba took the form of a dinner, at which about fifty members were present. The meeting was held at the Fort Garry Hotel on Monday, 24th April 1939.

Following the dinner, several enjoyable musical numbers were provided by Mr. Ed. Forrest, accompanied by Mr. Herbert Sadler.

Chairman Saul called the meeting to order, and briefly introduced Mr. W. E. Hodge, President of the Dominion Association of Chartered Accountants. In opening a discussion on Dominion Association affairs, Mr. Hodge referred to associations with the Manitoba Institute as far back as 1912. He also paid tribute to Mr. Keith Drennan, who was for many years Secretary of the Institute, in his efforts towards establishing standard examinations, and acknowledged the work which has but recently borne fruit.

Following an interesting and informative outline of the work of the present Dominion Council, Mr. James B. Sutherland on behalf of the Manitoba members proposed a vote of thanks to Mr. Hodge, which was carried with enthusiasm.

## OBITUARY

### **The Late Preble Macintosh, C.A.**

The Society of Chartered Accountants of the Province of Quebec regrets to record the death of Mr. Preble Macintosh, which occurred on April 30th.

The late Mr. Macintosh was a partner in the firm of Macintosh, Robertson & Paterson, and was one of the most highly esteemed members of the Quebec Society, having been admitted in 1900 and served on the Council from 1901 to 1903. His passing will be deeply felt by his colleagues and associates.

## **STOCK BROKERS' ACCOUNTS**

### **Theory and Practice**

This series of discussions on the subject of stock brokerage accounting theory and practice has been prepared by a group of members of the profession familiar with the subject. They desire to have it understood that the definitions, opinions and observations appearing in this column are their own and are not necessarily those of the Dominion Association.

*(Continued from May issue)*

### **Margin Department and Its Function**

The Margin Department of a broker's office records the customers' accounts in such a manner that, at all times (daily in an active market) the margin position of these accounts may readily be determined. A visible cardex system is frequently used, each card representing a customer's account and containing the balance of his account and the position of all securities related thereto. The usual signal tabs may be used to mark accounts for special attention.

By applying the market value of the securities held in any account, the equity on a forced liquidation may be determined and if this equity is sufficient to meet the margin requirements which have been set for the department, then this account is said to be "fully margined." If the equity is not sufficient, then the department must send out a "call" for funds or securities to replace this lost equity. If the call is not met, it is this department's duty to ask a partner of the firm for further instructions.

It is essential for the efficient functioning of this department that its records be kept up to the minute. To

facilitate this, the following forms must first be approved and initialled by the margin department.

1. All requisitions for cheques to customers
  2. All customers' orders, and
  3. All orders for delivery, transfer, etc., of securities.
- Further, copies of all confirmations, cash receipts and disbursements, etc. are immediately given to the margin department for entry.

The importance of this department's work cannot be over emphasized. If clients are permitted to let their accounts remain undermargined or only partly secured, then the broker is actually financing the shortage out of his capital with a consequent risk to the broker.

Arising out of this main function are other duties. It is customary for a broker to require the execution of a margin agreement between himself and his clients before opening a trading account. Special agreements are frequently obtained to cover accounts guaranteed by other clients or outside parties and the release of securities for delivery against short sales of other clients. It is the responsibility of this department to have a record of all such agreements at hand and notify the principals if these have not been received.

### **Insurance Coverage**

Stockbrokers may, in order to protect their capital investment, purchase a variety of bond and insurance coverage. The usual insurance so purchased consists of a Brokers' Blanket Bond which will cover losses occurring through:

1. Dishonesty of employees.
2. Losses of securities occurring inside the office, or on the premises of the insured's bankers, or when lodged for transfer, registration, etc.
3. Losses occurring while the property may be in transit in the custody of either the insured's own messengers, or anyone acting as his messenger.

The stockbroker should also insure himself for losses resulting from the taking as collateral, purchase, sale, or guarantee of endorsement, of invalid securities. Cheque forgery losses should also be covered both on incoming and outgoing cheques or drafts.

A major and frequent source of dishonesty loss to stock-brokers in recent years has been in connection with fraudulent trades on the part of employees. Even the broadest forms of Blanket Bonds differ in the rather limited coverage they provide so that it is necessary for the purchaser of a Brokers' Blanket Bond to read his bond carefully and also have it reviewed by his attorney or an expert in financial insurance in order that he may have some knowledge of the trading losses for which his surety is not liable.

Losses have occurred as the result of collusion between the brokers' employees and employees of other financial firms. This is a very difficult point to cover in a Brokers' Blanket Bond, but should be carefully considered when placing the bond. Instances have arisen where the broker has innocently received securities misappropriated by his client and later found himself liable to return same or their equivalent to the owner.

Brokers who are members of stock exchanges should protect themselves for liabilities which they assume because of the rules of such exchanges in reference to members' liability concerning the introduction of invalid securities into such markets. Members of stock exchanges must, of necessity, be prepared, as the result of such trades with other members, to substitute valid securities for those where the title is called in question. Most of the usual types of invalid securities are included in the coverage of the Securities Blanket Bond, which should be purchased by every stock or bond broker.

## TERMINOLOGY DEPARTMENT

The articles in this Department, unless otherwise stated, are originally written by the Chairman of the Terminology Committee and submitted to the members thereof; they are afterwards revised by him after consideration of suggestions made by the members.

If it should be thought that any articles include too much primary or elementary matter, readers are asked to realize that the Committee hopes these articles will be of especial value to Students-in-Accounts; and it is believed that, to impart a thorough understanding, too much emphasis cannot be placed on the fundamental principles on which the ideas connoted in the term defined are based.

*(Continued from May issue)*

**Profits Prior to Incorporation:** A company cannot make profits before it comes into existence. Sometimes a company is formed to take over an existing business with rights to the benefit of operations from a date prior to its incorporation; profits made in this interim are known as profits prior to incorporation, and being merged in the assets, are part of the net worth of the business as taken over.

**Pro Forma Balance Sheet:** pro forma, "for the sake of form" (Lat.). It may be applied in many ways to a balance sheet, e.g., to one drawn up as a suggestion for a form to be used, and which is thus subject to changes according to the ideas of directors or auditors. The most general use of the term, however, is in the case of a balance sheet for use in a prospectus, etc., in which the application of proposed new financing to the business as it stands shows the ultimate position.

**Promissory Note:** An unconditional promise in writing made by one person called the maker to another called the payee, signed by the maker, promising to pay on demand or at a fixed or determinable future time, a sum certain in money, to or to the order of a specified person, or to bearer (*Bills of Exchange Act*, Section 176).

**Property:** Anything owned. The word is practically indefinite in extent, and implies anything which a person owns or in which he has an interest.

**Proprietorship:** The sole ownership of a business. The owner is the "proprietor."

**Prospectus:** In its wider meaning this term refers to any descriptive circular or pamphlet. Hence the prospectus of a school, a college, book or library. In corporation finance, however, it refers to the circular, advertisement or

other invitation to the public made by a company to subscribe to its share capital or bonds. The following is the definition given in section 73 of *The Companies Act* (Dominion): "Prospectus means any prospectus, notice, circular, advertisement, letter or other graphic communication, offering to the public for subscription or purchase or other acquisition or indicating that there are available for subscription or purchase or other acquisition (and notwithstanding that such communication may state that the securities therein mentioned have been fully subscribed for or sold or that the communication is for the purpose of record only) any securities of a company issued or to be issued by it; provided that a communication in respect of a security shall not be deemed a prospectus (a) if it is proved that prior to such communication a prospectus as required by the provisions of this Act was mailed or delivered by or on behalf of the company to the person to whom the communication was made or (b) if the communication contains a *bona fide* statement that a prospectus, a copy of which has been filed under the provisions of this Act, will be promptly furnished on request, and contains no statement either of fact or opinion relating to the assets of the company owned or to be acquired, its earnings or prospective earnings, or to any business carried on or proposed to be carried on by it, except a statement specifying the nature of such business."

**Protest:** A formal statement of dissent or disapproval. As used in the *Bills of Exchange Act*, a written declaration by a notary or justice of the peace that a bill, note or cheque has been presented and payment or acceptance refused.

**Provision:** A charge against earnings or surplus to establish reserves for undetermined losses or liabilities or the estimated diminution in value of any property, e.g., bad debts, depreciation, income tax, etc. The word "reserve" is usually used in this regard, which often leads to some confusion, in that cases have been known of balance sheets which, under the heading "Reserves," show as a group reserves for depreciation, bad debts, income tax and general. Reserves created by provisions as described should not be so grouped together, but deducted from the book value of the assets concerned, or set up with the liabilities as the case may be.

## STUDENTS' DEPARTMENT

R. G. H. SMAILS, C.A., Editor

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### NOTES AND COMMENT

In the course of two recent lectures<sup>1</sup> delivered at the London School of Economics Professor T. H. Sanders of the Graduate School of Business Administration, Harvard University expressed the opinion (to which he had previously subscribed in "A Statement of Accounting Principles") that the use of secret reserves is not general in the United States except perhaps in the case of banks. He went on to say that it was pretty certain that none of the regulating commissions to which he had referred (the Interstate Commerce Commission, Federal Communications Commission, Securities and Exchange Commission, etc.) would knowingly tolerate the practice. "It is the general feeling," he said, "that earnings and surplus should be fully disclosed, and that if reserves are deemed desirable, they should be appropriated out of surplus and clearly shown on the balance sheet. Even among banking authorities there is some difference of opinion as to whether it would not be better for banks to disclose their situation fully." *The Accountant* (London) in its editorial comment upon the lectures remarked:<sup>2</sup> "It is a little surprising to us to read that in the United States the practice of using secret reserves is not general . . . we rather suspect that what Professor Sanders really means is that the problem of inner reserves has not attracted quite so much attention on his side of the Atlantic as it has on ours because other and more pressing questions fill the landscape; possibly American inner reserves express themselves in another way in the competition between capital surplus and earned surplus which seems so much more urgent and clamant in the United States than it does in England." *The Accountant* may be right in its diagnosis but it is easy to find oneself at cross purposes on the subject of secret reserves unless one has first agreed where "conservatism" ends and secret reserves begin.

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If Lord Bryce had written his "Modern Democracies" today instead of some twenty years ago he would have had

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<sup>1</sup>See *The Accountant*, Vol. C, Nos. 3359 and 3360.

<sup>2</sup>*Ibid.*, Vol. C, page 559.

an abundance of material with which to illustrate the autocratic form of government and to point the contrast between it and the democratic form. As it was his illustrations seemed to savour a little of the academic and classical. It is therefore surprising when reading the book today to find how entirely apt those illustrations are and how exactly autocracy follows the traditional pattern. There has been a tendency in some quarters over the past twenty years to belittle Bryce as a political philosopher. A re-reading of his works today is likely to reverse that trend and to elicit admiration for the acuteness of his reasoning and judgment.

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### STUDENT ASSOCIATION NOTES

#### ONTARIO—Toronto

The annual meeting of the Toronto branch of the Chartered Accountants' Student Association of Ontario was held at Hart House, University of Toronto, on April 12th last, and the speaker of the evening was Mr. Aubrey Bond, K.C. Rather than discuss matters of accountancy or business problems and on the theory that a change is as good as a rest Mr. Bond spoke on "A Philosophy of Life", suggesting that it is important that students consider seriously the principles and rules of life and living. Mr. Bond was introduced by Mr. Frank Buck, and Mr. Hennessy presided.

At this meeting Mr. W. G. H. Jephcott, C.A., outlined the recent changes which have been made in the curriculum and in the method of examination, and at the close of the meeting the results of the election for the new council were announced.

Several very successful discussion groups have been held during the past two months, and these groups, which have been well attended, have been of great value to the students. On April 24th Mr. W. H. Moore, C.A., discussed "Some Features of Gold Mine Accounts" with final year students, and on May 1st this group heard Mr. A. R. MacKenzie of Western Flour Mills speak on "The Canadian Grain Trade and Accounting". The intermediate groups were held under the leadership of Mr. K. E. Greenwood, C.A., who, during the course of the meetings, discussed the asset side of the balance sheet in its various aspects; the liability side will be discussed at the meetings to be held in the fall. The primary group concentrated on arithmetic and benefited



from the leadership of Mr. A. R. McMichael, C.A., a former examiner in that subject. Summer weather and baseball have brought these group meetings to a halt, but they will be resumed in the fall.

At the time of writing the baseball league is well under way, and this year ten firms have entered teams. The final game is scheduled for June 29th, and following this it is hoped that a tennis tournament will be organized which will last over a period of two weeks.

The annual golf tournament will be held on June 23rd, followed by a dance in the evening, and the attention of students living outside Toronto is especially directed to this date and a cordial invitation extended to them to be present at the tournament, the dance, or if possible at both.

### PROBLEMS AND SOLUTIONS

Solutions presented in this section are prepared by a practising chartered accountant of the Institute from whose examinations the problem is taken and represent his views and opinions. They are designed not as models for submission to the examiner but rather as such discussion and explanation of the problem as will make its study of benefit to the student. Discussion of solutions presented is cordially invited.

#### PROBLEM I.

#### THE INSTITUTE OF CHARTERED ACCOUNTANTS OF ONTARIO

#### INTERMEDIATE EXAMINATIONS, DECEMBER, 1938 ACCOUNTING NO. 1.

#### Question 7.

The following is the liability side of the consolidated balance sheet of X Company Limited and its subsidiary Y Company Limited as at December 31, 1937, as prepared by the accountant of the parent company:

#### Consolidated Balance Sheet

#### X Company Limited and its subsidiary, Y Company Limited, as at December 31, 1937

Current Liabilities—		Liabilities
Bank advances (net) .....		\$ 90,000
Accounts payable .....		110,000
Note payable .....		50,000
Sundry accrued liabilities .....		18,500
Income and other taxes payable in Canada ..		20,000
		<hr/> \$ 288,500

THE CANADIAN CHARTERED ACCOUNTANT

Funded Debt—		
5% bonds of Y Company Limited due January 2, 1940, at par .....	\$ 75,000	
Less—Held by X Company Limited \$20,000 par value bonds at 90 plus accrued interest of \$500 .....	18,500	56,500
Capital Stock—authorized and issued—fully paid:		
Preferred Stock—		
X Company Limited—6% .....	\$500,000	
Y Company Limited—6% .....	150,000	650,000
Common Stock—no par value—		
X Company Limited—25,000 shares .....	\$500,000	
Y Company Limited— 2,000 shares in hands of public—issue value thereof .....	100,000	600,000
Earned Surplus—		
X Company Limited .....	\$300,000	
Less—deficit Y Company Limited .....	20,000	280,000
Excess of issue value of 3,000 shares of Y Company Limited held by X Company Limited over value thereof as shown by books of X Company Limited .....		15,000
		<u>\$1,890,000</u>

The following additional facts are given:

- (a) The amount of \$15,000 shown as last item above comprises:  
 Cost of shares to X Company Limited ..... \$150,000  
 Less—Loss of Y Company Limited since acquisition, attributable to such holdings ..... 15,000

Carrying value ..... \$135,000  
 Issue value ..... 150,000

Difference ..... \$ 15,000

- (b) The common shares of Y Company Limited were all issued to the public at \$50 per share and the surplus of Y Company Limited at time X Company Limited acquired the 3,000 shares from the public amounted to \$1.00 per share.  
 (c) The note payable of \$50,000 represents a note of Y Company Limited payable to X Company Limited, which company discounted it at the bank.  
 (d) The inventories of X Company Limited include goods purchased from Y Company Limited at a profit of \$10,000 to that company.  
 (e) The bonds of Y Company Limited were issued at par but the holdings therein by X Company Limited were purchased on the open market at 90.  
 (f) The parent company has a contingent liability of \$25,000 in respect of the guarantee of an account payable by the subsidiary company.  
 1. Prepare journal entries showing adjustments you would make to the foregoing balance sheet.  
 2. Prepare working Liability side of the consolidated balance sheet showing adjustments and final figures.

## STUDENTS' DEPARTMENT

SOLUTION  
X COMPANY LIMITED CONSOLIDATED BALANCE SHEET, DECEMBER 31 1937

LIABILITIES		Preliminary		Adjustments		Final	
		Dr.	Cr.	Dr.	Cr.		
<b>Current Liabilities:</b>							
Bank advances (net) .....	\$ 90,000.00					\$140,000.00	
Accounts payable .....	110,000.00					110,000.00	
Notes payable .....	50,000.00					18,000.00	
Sundry accrued liabilities .....	18,500.00					20,000.00	
Income and other taxes payable in Canada .....	20,000.00						\$288,000.00
<b>Funded Debt:</b>							
5% bonds of Y Company Limited, due January 2 1940, at par .....	\$ 75,000.00					75,000.00	
Less—Held by X Company Limited—\$20,000.00 par value of bonds plus accrued interest of \$500.00 .....	18,500.00						
<b>Capital Stock of Subsidiary Company Held by the Public:</b>							
Preferred Stock .....	\$						
Common Stock, at book value .....	\$						
<b>Capital Stock — Authorized and Issued, Fully Paid:</b>							
Preferred Stock—							
X Company Limited—6% .....	\$500,000.00					500,000.00	
Y Company Limited—6% .....	150,000.00						
	\$650,000.00						
Common Stock—no par value—							
X Company Limited—25,000 shares ..	\$500,000.00					500,000.00	
Y Company Limited—2,000 shares in hands of public—issue value thereof ..	100,000.00						
	\$600,000.00						
<b>Earned Surplus:</b>							
X Company Limited .....	\$300,000.00						
Less—Deficit Y Company Limited .....	20,000.00						
	1,250,000.00					1,000,000.00	
<b>Capital Surplus</b> .....	\$						
Excess of Issue Value of 3,000 shares of Y Company Limited held by X Company Limited over value thereof as shown by books of X Company Limited .....							
	15,000.00					5,000.00	
	\$1,390,000.00						
							\$1,884,000.00

ADJUSTING JOURNAL ENTRIES

	Dr.	Cr.
(1) Sundry accrued liabilities .....	\$ 500	
Funded debt .....	1,500	
To Capital Surplus .....		\$2,000
To deduct accrued interest receivable on bonds from liability therefor on consolidated ac- counts; to state outstanding bonds at the par value thereof and carry the excess of issue value thereof over cost to Capital Surplus		
(2) Preferred Stock—Y Company Limited .....	150,000	
Common " —Y " " .....	100,000	
To Minority interests .....		250,000
To set up issue value of capital stock of Y Company Limited held by public in Minority interest account — Preferred and Common Stock Y Company Limited		
(3) Excess of issue value of shares Y Company Limited .....	15,000	
To Earned Surplus X Company Limited..		15,000
To reverse the entry on X Company Limited books whereby the investment in Y Company Limited was written down by X Company Limited share of Y Company Limited loss since acquisition		
(4) Minority interests—Common Stock .....	8,000	
To Deficit Y Company Limited .....		8,000
To charge the minority interests with 40% of the deficit of Y Company Limited		
(5) Deficit Y Company Limited .....	3,000	
To Capital Surplus .....		3,000
To set up surplus at date of acquisition rel- ative to the 3,000 shares Common Stock Y Company Limited held by X Company Limited		
(6) Notes payable .....	50,000	
To Bank advances .....		50,000
To increase liability to the bank in respect of inter-company note discounted		
(7) Surplus .....	6,000	
To Inventories .....		6,000
To provide for parent company's share of in- ventory profit included in accounts of X Com- pany Limited		

NOTE: It is unnecessary to make any reference on the consolidated balance sheet in respect of the guarantee of an account payable of the subsidiary company since such account payable is included as an actual liability in consolidation.

STUDENTS' DEPARTMENT

**PROBLEM II.**  
**THE INSTITUTE OF CHARTERED ACCOUNTANTS**  
**OF ONTARIO**

FINAL EXAMINATIONS, DECEMBER, 1938

**Accounting No. 2. Question No. 4**

The Balance Sheet of A.B.C. Company Limited, at 31st May, 1938, in summarized form was as follows:

**ASSETS**

Cash on hand and in banks .....	\$ 5,000.00
Accounts and Bills Receivable, less reserves .....	810,000.00
Inventories .....	800,000.00
Plant, less depreciation reserves .....	2,700,000.00
Goodwill .....	100,000.00
Deficit .....	200,000.00
	<u>\$4,615,000.00</u>

**LIABILITIES**

Bank Loan, secured under Section 88 .....	\$ 400,000.00
Accounts and Bills Payable .....	2,000,000.00
Note to Director—payable on 31st May, 1938 .....	15,000.00
Bonds—1st Mortgage 6% bonds .....	1,400,000.00
Arrears of interest to 31st May, 1938 .....	100,000.00

**Capital Stock**

Authorized and issued:

**Preferred:**

6% Redeemable Cumulative 1,000 shares of \$100.00 each .....	100,000.00
(dividends unpaid for 3 years)	

**Common:**

60,000 shares of \$10.00 each .....	600,000.00
	<u>\$4,615,000.00</u>

The Company arranged a reorganization by the proper procedure replacing existing liabilities and capital in the following manner:

- (1) A new group provided \$1,000,000.00 additional cash for the business for which they received new 5% first mortgage bonds, repayable \$100,000.00 per annum for 10 years.
- (2) The indebtedness to the bank was repaid.
- (3) General creditors received 25% cash and a new issue of General Bonds for the balance due to them. The new General Bonds were repayable as follows: Interest at 5% per annum, payable in 2nd preferred stock at par for the first five years, at the end of each year, and thereafter quarterly in cash.

Principal repayments to commence after the first mortgage bonds had been repaid—and would then be at the rate of \$150,000.00 per annum.

## THE CANADIAN CHARTERED ACCOUNTANT

- (4) The director's note, with interest at 3% from 31st May, 1938, to be extended for two years.
- (5) 1st Mortgage Bondholders to receive one new 1st Preferred share at \$100.00 par value for each \$100.00 bond, plus the arrears of interest thereon.  
The first Preferred Stock to be 5% cumulative and to participate with the second Preferred Stock, on dividends paid on the second Preferred Stock in excess of 3%.
- (6) Present Preferred Shareholders to receive new second preferred shares, share for share, and one new Common share for each \$10.00 of arrears of dividends. Second Preferred Stock to be 3% non-cumulative—participating with first preferred on 2% additional dividends as available.
- (7) Common Shareholders to receive  $\frac{1}{2}$  share of new no par value common shares for each old share held.  
The value set for the new common shares of no par value to be \$1.00 per share and any surplus resulting from the reorganization to be applied first in reduction of the intangible assets, and secondly in reduction of the book value of plant.
- (a) Outline the procedure required for the company to obtain authority for the reorganization.
- (b) Give the Journal Entries to give effect to the reorganization and prepare the new Balance Sheet on completion of reorganization.
- (c) The operating profits of the company during the subsequent 3 years, excluding all financial charges, were as follows:

Year ended 31st May, 1939—	\$150,000.00
31st May, 1940—	200,000.00
31st May, 1941—	500,000.00

The directors declared dividends when profits were available.

Prepare a summary of the Profit and Loss and Surplus Accounts for each of the three years.

### SOLUTION

The following journal entries give effect to the transactions resulting from the reorganization of the Company:

- |  |                |                |
|--|----------------|----------------|
| 1. Bank .....  | \$1,000,000.00 |                |
| To First Mortgage 5% Bonds, new issue .....  |                | \$1,000,000.00 |
| To record receipt of cash and issue of \$1,000,000.00 in bonds.  |                |                |
| 2. Bank Loan secured under Section 88 of the Bank Act .....  | 400,000.00     |                |
| To Bank Disbursement .....   |                | 400,000.00     |
| To record repayment of Bank Loan.  |                |                |
| 3. Accounts and Bills Payable .....  | 2,000,000.00   |                |
| To Bank Disbursement .....   |                | 500,000.00     |
| To General 5% Bonds .....  |                | 1,500,000.00   |
| To record settlement of General creditors by cash payment of 25% of claims and issue of General 5% bonds for balance due them in accordance with arrangement approved by shareholders and Court. |                |                |

# STUDENTS' DEPARTMENT

4. First Mortgage 6% Bonds (Old issue)	1,400,000.00	
Arrears of Interest on First Mortgage 6% Bonds to 31st May 1938 .....	100,000.00	
To Old Bondholders .....		1,500,000.00
To record cancellation of Old First Mortgage 6% Bonds and arrears of Interest to 31st May 1938.		
5. Old Bondholders .....	1,500,000.00	
To First Preferred 5% Cumulative Participating Capital Stock ....		1,500,000.00
To record issue to Old Bondholders of 15,000 First Preferred 5% Cumulative Participating Shares of \$100.00 par value in settlement of claims of Old First Mortgage Bonds and arrears of interest thereon in accordance with agree- ment dated .....1938, ap- proved by the shareholders and by Supplementary Letters Patent dated.....1938.		
(One share of First Preferred Stock issued for each \$100.00 Old First Mortgage Bond held, plus the ar- rears of interest thereon.)		
6. Old 6% Redeemable Cumulative Prefer- red Shares .....	100,000.00	
To New Second Preferred 3% Non- Cumulative Capital Stock .....		100,000.00
To record issue of 1000 New Second Preferred 3% non-cumulative participating Capital Stock of \$100.00 par value each in exchange for 1000 old 6% Redeemable Cumulative Preferred Shares, share for share, as per agree- ment, dated approved by share- holders and confirmed by Supple- mentary Letters Patent dated .....1938.		
7. Surplus on Reorganization .....	1,800.00	
To New Common Capital Stock of No Par Value .....		1,800.00
To record issue of 1800 shares of Common Stock of No Par Value in settlement of arrears of divi- dends on old 6% Cumulative Pre- ferred shares on basis of issue of one New Common share for each \$10.00 of arrears of dividends.		
8. Old Common Shares .....	600,000.00	
To New Common Capital Stock of No Par Value .....		12,000.00
Surplus on Reorganization .....		588,000.00

# THE CANADIAN CHARTERED ACCOUNTANT

To record exchange of 60,000 Old Common shares of \$10.00 each for 12,000 New Common shares of No Par Value issued at \$1.00 per share in accordance with agreement with shareholders and Supplementary Letters Patent dated .....1938.  
The exchange basis is 1/5 New Common Shares for each Old Common Share held.

9. Surplus on Reorganization .....	586,200.00	
To Deficit Account .....		200,000.00
Goodwill .....		100,000.00
Plant .....		286,200.00
Surplus on Reorganization applied to write off the balances in Deficit and Goodwill accounts and the balance applied in reduction of the book value of Plant.		

## A. B. C. COMPANY LIMITED BALANCE SHEET AS AT 31st MAY, 1938 ON COMPLETION OF REORGANIZATION

### ASSETS

#### Current Assets:

Cash on hand and in Banks .....	\$ 105,000.00	
Accounts and Bills Receivable, Less Reserves .....	810,000.00	
Inventories .....	800,000.00	
		1,715,000.00

#### Fixed Assets:

Plant .....	2,413,800.00
	<u>\$4,128,800.00</u>

### LIABILITIES

#### Funded Debt:

Note payable to Director—@ 3% interest, due 31st May 1940 .....	\$ 15,000.00	
First Mortgage, 5% Bonds, repayable \$100,000.00 per annum .....	1,000,000.00	
General Mortgage 5% Bonds (Interest payable in First Preferred stock for 5 years)		
Principal repayable \$150,000.00 per annum commencing after the first mortgage bonds have been retired in full .....	1,500,000.00	2,515,000.00



# STUDENTS' DEPARTMENT

## Capital Stock—Authorized and Issued— fully paid:

First Preferred 5% Cumulative Shares participating with second preferred dividends in excess of 3% 15,000 shares of \$100.00 each ....	1,500,000.00	
Second Preferred 3% Non-Cumulative Shares (Participating with first pre- ferred additional 2% as available) 1,000 shares of \$100.00 each .....	100,000.00	
Common Shares 13,800 shares of no par value ....	13,800.00	1,613,800.00
		<u>\$4,128,800.00</u>

## PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 31st MAY, 1939

Operating Profit for Year .....	\$150,000.00
<b>Deduct: Financial Charges</b>	
Interest on Director's Note 3% of \$15,000.00.\$	450.00
Interest on Bonds	
First Mortgage Bonds 5% on \$1,000,000.00	50,000.00
General Mortgage Bonds 5% on \$1,500,000.00 payable by issue of 750 shares 1st Preferred Stock .....	75,000.00
	<u>125,450.00</u>
Net Profit for year carried to Surplus Account .....	\$ 24,550.00

## SURPLUS ACCOUNT

Balance from Profit and Loss Account being profit for the year ended 31st May 1939 ....	<u>\$ 24,550.00</u>
--	---------------------

## PROFIT AND LOSS ACCOUNT For the Year Ended 31st May, 1940

OPERATING PROFIT FOR YEAR .....	\$200,000.00
<b>Deduct: Financial Charges</b>	
Interest on Director's Note 3% \$15,000.00 \$	450.00
Bond Interest	
First Mortgage 5% Bonds 5% on \$900,000.00 .....	45,000.00
General Mortgage 5% Bonds 5% on \$1,500,000.00 .....	75,000.00
payable by issue of 750 shares 1st Preferred Stock	120,000.00
	<u>120,450.00</u>
Net Profit for the Year carried to Surplus Account	<u>\$ 79,550.00</u>

THE CANADIAN CHARTERED ACCOUNTANT

**SURPLUS ACCOUNT**

For the Year Ended 31st May 1941

Balance 31st May 1939 .....	\$ 24,550.00
Profit for year ended 31st May 1940 .....	79,550.00
	<u>\$104,100.00</u>
Deduct: Arrears of Dividend at 5% on \$1,500,000.00	
First Preferred Stock for the year ended 31st May 1939 .....	75,000.00
	<u>\$ 29,100.00</u>

**PROFIT AND LOSS ACCOUNT**

For the Year Ended 31st May, 1941

OPERATING PROFIT FOR YEAR .....	\$500,000.00
Deduct: Financial charges	
Bond Interest	
First Mortgage Bonds	
Interest at 5% on \$800,000.00 .....	\$ 40,000.00
General Mortgage Bonds	
Interest at 5% on \$1,500,000.00 ....	75,000.00
(Payable by issue of 750 shares 1st Preferred Stock) .....	115,000.00
	<u>\$385,000.00</u>
Net Profit for Year carried to Surplus Account	<u>\$385,000.00</u>

**SURPLUS ACCOUNT**

For the Year Ended 31st May, 1941

Balance 31st May 1940 .....	\$ 29,100.00
Profit for the year ended 31st May 1941 .....	385,000.00
	<u>\$414,100.00</u>

**Deduct:**

Dividends on First Preferred Stock:			
Arrears of Dividend for year ended			
May 31st 1940, 5% of \$1,575,000.00	\$	78,750.00	
Regular Dividend 5% of \$1,650,000.00		82,500.00	
Participating Dividend			
of 2% of 1,650,000.00		33,000.00	
		<u>\$194,250.00</u>	

**Dividends on Second Preferred Stock:**

Regular Dividend of			
3% of .....	\$100,000.00	\$3,000.00	
Participating Dividend			
of 2% of .....	100,000.00	2,000.00	5,000.00
			<u>199,250.00</u>

Balance 31st May 1941 available for Dividends on Common Shares	<u>\$214,850.00</u>
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**Note:** Provisions for Income Taxes have been omitted as the question does not state in what provinces the company operates, and such provision would have to be a rough estimate.

THE  
CANADIAN CHARTERED  
ACCOUNTANT

INDEX  
OF  
SUBJECTS AND CONTRIBUTORS

VOLUMES XXVII TO XXXIV  
(July 1935 to June 1939)

*(ISSUED AS A SUPPLEMENT TO THE JUNE 1939 NUMBER)*

## SUBJECTS

	VOLUME	PAGE
Accountancy, Constructive, George R. Freeman .....	29	257
Accountancy education, Progress in—editorial comment ..	34	239
Accountancy examinations of Canada, Austin H. Carr .....	33	362
Accountancy, Fund consciousness—A forgotten aspect of commercial, William Macintosh .....	30	188
Accountancy profession in Great Britain, The—editorial comment .....	33	331
Accountancy—reference to journal .....	33	467
Accountancy, The future of the profession of, Hon. J. H. McQuarrie .....	27	117
Accountancy—Wider horizons, George O. May .....	30	295
Accountant and industrial and public relations, The, J. E. Brower .....	31	8
Accountant an independent contractor—editorial comment ..	34	8
Accountant in relation to business and government in Great Britain, The position of the public, Sir Laurence Halsey .....	33	373, 434
Accountant in Russia to-day, Some problems for the, J. F. Close .....	28	99
Accountants, Alleged negligence of—Irish Free State case ..	30	89, 137
Accountants and auditors, Degrees of liability of—reference to <i>Pendlebury's</i> case .....	29	169, 223
Accountants and national service—editorial comment ....	34	163
Accountants and tax evasion—editorial comment .....	33	176
Accountants and the public—reference to address of Walter Holman, London .....	32	190
Accountants as business investigators—editorial comment ..	29	421
Accountants' certificates and inventories .....	34	199
Accountants, Educating—editorial comment .....	33	173
Accountants in public office—editorial comment .....	33	332
Accountants, New Zealand Society of—reference thereto ..	34	55
Accountants of Australia celebrating fiftieth anniversary..	30	160
Accountants' reports and audited accounts from an investment analyst's viewpoint, Dwight P. Robinson, Jr. ..	34	187
Accountants' reports, The supervision of, Stephen Chan ..	34	261
Accountants' reports, High standard in the appearance, content and grammatical construction of, Robert D. Gracey ..	32	372
Accountants—Some observations on the profession, George Cochrane .....	34	110
Accountants under Securities Act of 1933 of United States, Liabilities of .....	29	90, 135
Accountant's working papers—editorial comment .....	28	383; 34 6
Accountant, The future of the, Lord Stamp .....	34	344
Accounting and auditing, Municipal, A. B. Shepard .....	28	50
Accounting and the business executive, Philip H. Hensel ..	28	123
Accounting as an aid to industry, Milton Howard .....	29	183
Accounting by tabulating machines, Philip H. Hensel ....	30	479
Accounting congresses in France and Italy .....	31	53, 125
Accounting, Development of farm—editorial comment ....	27	145
Accounting examinations, Technical preparation for, Howard F. Greene .....	30	445, 503
Accounting, Fifth International Congress on—references thereto .....	30	488; 31 390; 32 486; 33 465
Accounting, Food cost, J. R. Hendry .....	31	154
Accounting for an interurban motor coach company, Harold S. Moffet .....	32	160
Accounting for depreciation in telephone work, F. A. Bowman .....	29	112

	VOLUME	PAGE
Accounting for gold mining companies, George C. Andrew	28	236, 360
Accounting for hospitals—see "Hospital Accounting."		
Accounting for municipalities with respect to unnegotiated debentures and debenture principal and interest in default, W. S. Tory	28	104
Accounting for returnable containers, Charles W. Smith	33	17
Accounting for revenue of time sales financing companies, V. Randolph Clerihue	30	476
Accounting in a gas or electric public utility company, Some problems of, G. Meredith Smith	28	179
Accounting in Canada, The development of the profession of, R. R. Thompson	34	171
Accounting machines	32	187
Accounting, Newspaper, Oscar H. Harder	29	9
Accounting, Oil and gas well, Fred E. Squire	27	174
Accounting, Other aspects of agricultural, W. F. Chown	28	334
Accounting practice and legislation—editorial comment	34	395
Accounting principles—editorial comment	33	92
Accounting principles, Statement of—editorial comment	32	325
Accounting profession, An address on the, George C. Cochrane	33	262
Accounting profession and the economists, The—editorial comment	31	150
Accounting profession—Dipping into the future—editorial comment	34	323
Accounting, Progress in, Austin H. Carr	33	121
Accounting research association in England—reference thereto	30	91
Accounting research in Great Britain—editorial comment	32	324
Accounting, Some functions of—editorial comment	28	93
Accounting, Some problems of university, J. E. Brower	28	304
Accounting system for a subscription book company, Merrick B. Davidson	32	8
Accounting system for gold mining companies prior to production, Frank Willcox	28	316
Accounting terminology is different—humorous reference	34	212
Accounting, Trust company, M. W. Waddington	31	366
Accounts, A few remarks on balance sheets and profit and loss, Russell Kettle	34	410
Accounts and audit of a fire insurance company, The, H. B. Clearihue	34	401
Accounts, Brewery, W. L. Lucas	33	97
Accounts, Form of published—editorial comment	34	399
Accounts, Improvement in financial—editorial comment	33	3
Accounts, Improvement in financial, George O. May	33	42, 106, 200
Accounts, International—with special reference to Canada's balance of international payments, Frank A. Knox	29	93, 195, 296, 384
Accounts, Lawyers', J. Grant Glassco	31	19
Accounts of a mortgage loan company, Irvin T. Hunt	32	428
Accounts of a small oil refinery, The, Milton Howard	34	247
Accounts of Canada, The public, George C. McDonald	30	377
Accounts of executors and trustees, T. A. Morrow	28	391; 29 21
Accounts, Rules respecting (Law Society of Upper Canada)	30	151
Accounts, Solicitors' rules respecting (Alberta)	27	355
Accounts, Stock brokers'	34	64, 143, 223, 303, 376, 450
Accounts, Stock brokers'—editorial comment	34	8

	VOLUME	PAGE
Accounts—Suggested system for a social welfare agency, Milton Howard .....	31	39
Account, The arithmetic of the grain trading, William Macintosh .....	34	326
Administration of the Canadian income tax law, C. Fraser Elliott .....	33	268
Administration, The quality of—editorial comment .....	32	422
Advertising accountant, The menace of the .....	32	40
Advertising agency accounting, Arthur E. Jubien .....	30	383, 489
Agricultural accounting, Some aspects of, F. G. Winspear Agricultural marketing schemes and the <i>Natural Products</i> <i>Marketing Act</i> , John E. McCallum .....	27	88
Agriculture a national industry—editorial comment .....	28	342
Agriculture declining, Relative importance of—editorial comment .....	29	424
Agriculture, The problems of—editorial comment .....	27	82
Agriculture, Wider view needed in—editorial comment ...	28	300
Alberta, A summary of the reports of the royal commissions on the natural resources of Saskatchewan and .....	34	158
Alberta legislation, Recent, G. R. G. Baker .....	27	188
Alberta legislation relative to adjustment and reduction of debts, E. J. Chambers .....	29	321
Alberta notes— <i>The Income Tax Act</i> amended .....	29	470
Alberta's debt, Report on .....	31	463
American Institute of Accountants, Anniversary of—(1937)	29	403
—Address of President Robert H. Montgomery .....	31	80, 313
American Institute of Accountants, 1935 annual meeting of the .....	31	393
American Institute of Accountants, 1936 annual meeting of the .....	31	374
American Institute of Accountants, 1938 annual meeting of the .....	27	206, 429
American Institute of Accountants, The—reference to an- niversary publications .....	29	238, 491
Annuities, Rates of government .....	33	388
Annuities, Succession duty-free—editorial comment .....	32	398
Appeals in criminal cases to the privy council .....	29	403
Application of funds statement—editorial comment .....	33	95
Arbitrary valuation of British goods .....	27	270
Assessments, Rental values and—editorial comment .....	32	312
Asset appraisals and accounting, Fixed, John A. Wilson ..	27	431
Audited accounts from an investment analyst's viewpoint, Accountants' reports and, Dwight P. Robinson, Jr. ..	31	421
Audit—False economy—editorial comment .....	30	97
Audit of brokerage houses—A system devised to reduce the routine, K. E. Greenwood .....	34	187
Audit of executors' accounts, On the, W. Gordon Firstbrook	32	2
Audit of a fire insurance company, The accounts and, H. B. Clearihue .....	32	20
Audit of municipal accounts—A Quebec case .....	27	8
Audit of municipal accounts in the Province of Quebec ..	34	202
Audit seekers—editorial comment .....	34	292
Auditing procedure, Extensions of—Report of special com- mittee of American Institute of Accountants .....	33	249
Auditing procedure, Report on—editorial comment .....	34	431
Auditor and the embezzler, The—editorial comment .....	34	396
Auditor, the client and the public, The, Howard I. Ross ..	32	78
	32	229

	VOLUME	PAGE
Auditors and of management, Responsibilities of—the <i>Interstate Hosiery</i> case—editorial comment .....	34	398
Auditors and provisions for depreciation—editorial comment .....	33	247
Auditors are not prophets—editorial comment .....	29	172
Auditors, Court action against, ( <i>Pendleburys Limited</i> Case)—editorial comment .....	28	298
Auditors, Court case respecting— <i>In re P. S. Catterson and Sons, Limited</i> .....	30	281, 326
Auditors in France—reference thereto .....	27	309
Auditor's position, "In our opinion" the—editorial comment .....	33	248
Auditor's report to the shareholders be changed? Should the statutory form of the—summary of round table discussion, K. W. Dalglish .....	33	453
Auditor's report to the shareholders, C. A. Ashley .....	34	118
Auditor's report to the shareholders, Further comments on the .....	34	49, 121
Auditor's report to the shareholders, The—memorandum of roundtable discussion at annual meeting .....	33	63
Auditor's report to the shareholders, The—forms of certificates .....	33	135
Auditor's report, The—editorial comment .....	30	178
Auditor's report, The—references thereto .....	31	83, 110
Auditors, shareholders and balance sheets .....	29	487
Audits, Bidding for .....	33	228
Audits, Public service in stock exchange, W. E. Dunton .....	27	256
Australasian congress on accounting—editorial comment .....	30	277
Australia attaining uniform company law—editorial comment .....	29	337
Australian recovery plan, The, W. T. G. Hackett .....	28	18
Australia's courageous policy—public debts—editorial comment .....	34	87
Australia, The chartered accountants in .....	30	423
Australia, The profession in .....	28	142
Automobile distributor, The accounts of an, V. Randolph Clerihue .....	31	353
Aviation in Canada, Civil .....	31	289
Balance sheet and the layman, The, R. G. H. Smalls .....	29	362
Balance sheet made plain, The—editorial comment .....	30	177
Balance sheet, Some thoughts on the, A. J. J. Fanshaw .....	29	346
Balance sheets and profit and loss accounts, A few remarks on, Russell Kettle .....	34	410
Balance sheets, their use, abuse and limitations, A. E. Cutforth .....	30	202
Balances, Unclaimed—Are they trading profits?—reference to English court case .....	34	54
Banking, Canadian, Mayne D. Hamilton .....	29	375, 458
Banking operations—editorial comment .....	33	409
Bank of Canada—annual statement as at 31st December, 1935 .....	28	205
Bank of Canada, J. A. C. Osborne .....	28	195
Bank of Canada—Notes on its organization and accounting system, Eric Fricker .....	29	33
Bank of Canada, Shareholders .....	29	66
Bank of Canada, The open market operations of the, A. F. W. Plumtre .....	33	421
Bank of Canada, The—reference to capital stock and how held .....	32	199

	VOLUME	PAGE
Bank of England, The, F. Bradshaw Makin .....	34	33
Bank of France, The—editorial comment .....	33	411
Bankruptcies and liquidations, Douglas L. Rose .....	30	305
Bankruptcy and secured and preferred creditors, Trustees in, Lewis Duncan .....	29	145
Bankruptcy, Licensing trustees in .....	33	308
Bankruptcy, 1935 report of Superintendent of .....	29	403
Bankruptcy, 1936 report of Superintendent of .....	31	462
Banks have numerous shareholders, Chartered .....	32	198
Bible—Guide to statesmanship—editorial comment .....	32	326
Bonded indebtedness and relative sinking fund, Subsidiary records of, V. Randolph Clerihue .....	27	390
Bookkeeping—historical reference (Robinson Crusoe) ....	30	110
Book Reviews—		
<i>Accounting (Part I)</i> , Rowland and Magee .....	30	72
<i>Accounting (Part I)</i> , revised edition, Rowland and Magee .....	34	301
<i>Accounting Principles and Practice</i> , Geoffrey Car- michael .....	29	497
<i>A Concise Manual of Statistics</i> , Clement Burton .....	31	135
<i>An Outline of Statistics</i> , Samuel Hays .....	33	78
<i>A Statement of Accounting Principles</i> , Sanders, Hat- field and Moore .....	32	404
<i>Auditing</i> , R. G. H. Smalls .....	30	164
<i>Audits</i> , A. E. Cutforth .....	30	71
<i>Audit Working Papers</i> , Maurice E. Peloubet .....	32	55
<i>Bibliography of Works on Accounting by American     Authors</i> , Harry C. Bentley and Ruth S. Leonard .....	27	293
<i>Business Organization and Administration</i> , W. A. McKague .....	27	365
<i>Cemetery Accounts</i> , Walter Mucklow .....	27	440
<i>Cost Accounting—Principles and Methods</i> , Charles Reitell .....	32	206
<i>Essays in Political Economy</i> , edited by H. A. Innis ..	32	496
<i>How to Make Your Business Live</i> , R. M. Haultain ..	27	135
<i>Industrial Relations</i> , Papers presented at a conference on industrial relations at Queen's University ....	34	139
<i>Insurance and Banking—Examinations and Accounting</i> , Herbert L. Davis .....	30	344
<i>Introduction to Cost Accounting</i> , Norman Lee Burton ..	30	71
<i>Local Authorities: Internal Financial Control</i> , A. H. Marshall .....	30	434
<i>Lumber Accounts</i> , Walter Mucklow .....	30	345
<i>Management Planning and Control</i> , A. G. Dent .....	27	294
<i>Municipal Accounting Statements</i> , National Committee on Municipal Accounting .....	29	498
<i>Municipal Administration and Accounting</i> , C. M. Wrenshall .....	31	402
<i>My Memories</i> , Thomas Brentnall .....	32	405
<i>Origin and Evolution of Double Entry Bookkeeping</i> , Edward Peragallo .....	34	221
<i>Quebec Company Statutes: Annotated</i> , Gerald H. Phil- imore .....	33	396
<i>Standard Procedure in Auditing</i> , W. J. Black .....	32	406
<i>The Development of the Business Corporation in Eng-     land 1800-1867</i> , Bishop Carleton Hunt .....	29	499
<i>The Dominion Companies Act 1934 Annotated</i> , W. S. Lightall .....	28	76



## Book Reviews—Continued

	VOLUME	PAGE
<i>The Law Relating to Income Tax of the Province of Quebec</i> , Herbert A. W. Plaxton .....	34	139
<i>The Nature of Dividends</i> , Gabriel A. Preinreich .....	27	440
<i>The Preparation and Use of Audit Records</i> , V. W. Holland .....	27	295
<i>Twenty-five Years of Accounting Responsibility, 1911-1935</i> , George O. May .....	29	409
<i>Uniform System of Accounts for Electric Utilities</i> .....	31	134
<i>Uniform System of Accounts for Gas Utilities</i> .....	31	133
Branch accounting principles as applied to salmon cannery accounts, Salmon canning and, L. R. Sinclair .....	33	284
Brewery accounts, W. L. Lucas .....	33	97
Britain's unpaid war debt—editorial comment .....	34	243
British Columbia fisheries .....	29	320
British Columbia notes—re municipal act .....	30	65
British-Italo trade pact .....	32	304
Brokerage office, Revenue and expense statistics in a, Gilbert A. Doe .....	31	212
Brokers' accounts, Stock—editorial comment .....	34	8
Brokers' marginal transactions—editorial comment .....	27	306
Budgetary control, Some elementary aspects of, C. N. Knowles .....	33	414
Budget, Control exercised through the medium of the, E. H. Banks .....	30	285
Budgets, Advantages and uses of, Philip H. Hensel .....	30	11
Budgets, Three British dominions have balanced .....	28	437
Building, Canada leads world in new .....	28	70
Building, Economic design for, W. A. McKague .....	30	34
Bureaucracy in government—editorial comment .....	34	159
Business and government, Some problems as between, Kris A. Mapp .....	33	192
Business cycle, The—editorial comment .....	33	93
Business investigation, J. Grant Glassco .....	29	430
<i>Business Profits War Tax Act</i> —re-enacted .....	30	359
Calendar reform—editorial comment .....	28	162
Canada, Map of .....	31	463
Canada, Public debts of—editorial comments .....	34	86, 240
Canada's leading markets .....	29	320
Canada's monetary system explained—editorial comment .....	32	321
Canada's wheat problem, G. R. G. Baker .....	34	270
Canada Year Book, The 1938 .....	33	308
Canadian-American affairs, Second conference on .....	31	50
Canadian foreign trade; also that with South Africa .....	28	361
Canadian public bonds outstanding and maturing .....	28	141
Capital, Company legislation in regard to the acquiring of initial, C. E. Walker .....	31	31
Capital fund in the interests of shareholders and creditors of the company, The conservation of the, C. E. Walker .....	31	100
Centralized control and decentralized management, J. L. Charlesworth .....	29	29
Chartered Accountants in England and Wales, Hall of Institute of .....	31	290
Chartered accountants—Making known our functions—editorial comment .....	31	315
Chartered Accountant Students' Society of London—references thereto .....	27	3, 384
Cheque case in Australia, A .....	28	360
China, The profession in—editorial comment .....	29	425

	VOLUME	PAGE
Civil servant of the future, The—editorial comment .....	33	176
Civil service of Canada—reference to positions .....	32 196, 303; 34 290,	366
Clarity of thought and expression—editorial comment ....	27	5
Coffee destruction—A method of maintaining prices .....	28	277
Coffee imports .....	29	320
Commerce courses at Manitoba University .....	31	290
Commerce, The debt of culture to, R. R. Thompson .....	30	48
Commerce, World—editorial comment .....	34	1
Companies Act (Dominion), The—Some comments and descriptions in published financial statements .....	28 138, 203	
	30 156, 260, 335; 32 193; 34 291	
Companies Act, 1934, Amendments to—Parliamentary discussions thereon .....	27	93, 162
Companies Act, 1934 (Dominion) and the amendments of 1935, The, R. J. Dilworth .....	27	408
Companies Act, Some suggested reforms to the Dominion, R. R. Thompson .....	31	188
Companies Act, The Dominion—respecting the interpretation of section 83(1), C. B. Wade .....	28 256, 359	
Companies—Holders of preferred shares—references to court case .....	29 254, 326	
Company law, Conference on—editorial comment .....	29	422
Company law, Towards uniformity in—editorial comment ..	31	151
Company legislation in Canada .....	30	262
Company legislation in France—editorial comment .....	27	308
Company legislation—See "Capital" and "Capital fund"		
Company reorganization (See "Legal Decisions")		
Company reports, More informative—editorial comment ..	29	173
Containers, Accounting for returnable, Charles W. Smith ..	33	17
Contributors, About our—editorial comment .....	34	83
Contributors of articles published each month, Notes on		
	28	358, 435
	29	64, 147
	30 62, 155, 259, 333, 421,	488
	31 53, 125, 217, 394,	462
	32 49, 129, 193, 298, 396,	486
	33 67, 144, 228, 307, 387,	466
	34 53, 130, 209, 290, 365,	449
Co-operative marketing—editorial comment .....	30	179
Co-ordination of public services—editorial comment .....	29	423
Coronation of King George VI, reference to .....	30	357
Corporate reports, Philip H. Hensel .....	27	400
Correspondence .....	27 292; 28 145, 282; 29 329; 30 163; 31 475;	
	32 135, 407; 33 74, 157, 472	
	34 63, 140, 302, 445	
Cost accounting—reference to review of essay of R. S. Edwards—editorial comment .....	32	140
Costing and control in a shoe manufacturing business, Rutherford Williamson .....	32	81
Costing "joint products"—editorial comment .....	30	269
Costs, A budget procedure through standard .....	27	330
Costs, Differential or marginal, R. G. H. Smalls .....	34	256
Costs, Farm—editorial comment .....	34	157
Costs in the packing industry, A study of, James C. Cameron .....	28	428
Costs on profits, The effect of fixed, A. S. Hallamore .....	34	17
Costs—variance between standard and actual—editorial comment .....	32	61
Credit, German long-term—editorial comment .....	34	5

	VOLUME	PAGE
Credit, How much—editorial comment .....	33	410
Credit, Professor W. Russell Maxwell .....	28	39
Credit, The provision of .....	27	288
Crow's Nest Pass Company case—an exchequer court decision .....	28	94
Currencies, Devaluation of .....	29	404
Currency and credit in Canada, Hon. Charles A. Dunning .....	32	341
Currency, Blocked [German trade methods]—editorial comment .....	34	3
Currency devaluation problems—editorial comment .....	29	428
Currency stabilization, J. P. Day .....	29	450
Customs, excise and income tax revenue .....	27 287, 430; 29 148, 492; 32 197, 487	
Dairy industry in Canada, The, C. W. Saddington		
Butter .....	29	441
Cheese .....	31	204
Milk .....	28	423
Production records for dairy plants .....	29	103
Dairy industry, The—editorial comment .....	27	147
Debt legislation, The effect of, G. R. G. Baker .....	33	213
Defalcations of employees—editorial comment .....	32	76
Democracy, Public service in a, Hon. J. L. Ilsley .....	33	343
Depletion in metal mines for income tax, Stanley B. Laing .....	32	328
Depreciation—see also "Obsolescence"		
Depreciation allowance under the <i>Income War Tax Act</i> , Rowland Swift .....	32	385
Depreciation, An accountant's point of view respecting— with reference to the case of <i>International Railway Company v. The Niagara Parks Commission</i> , George P. Keeping .....	33	298
Depreciation and the accounting period—editorial comment .....	32	157
Depreciation, Appraisal for—editorial comment .....	32	156
Depreciation, Auditors and provisions for—editorial comment .....	33	247
Depreciation charges on the basis of business volume, George Abrams .....	27	344
Depreciation in telephone work, Accounting for, F. A. Bowman .....	29	112
Depreciation on containers — see "Correspondence" and "Legal Decisions"		
Depreciation studies—reference thereto .....	30 160, 435	
Depreciation table, A—Reducing balance method .....	29	308
Directors—See "Management"		
Directors' responsibilities in France—reference thereto ..	27	308
Disinheritance of dependants by testator—editorial comment .....	31	149
Dividends of co-operative societies .....	27	359
Dividends paid out of depreciation and depletion reserves—a court case .....	27	105
Dividends, Stock—editorial comment .....	34	70
Dominion Association of Chartered Accountants, The—		
Annual meeting 1935—references thereto 25 1, 2, 79, 80, 81, 227, 279		
Group photograph annual meeting at Winnipeg ....	27 facing 227	
Matters of interest to members .....	28 67, 137, 201, 275, 358, 435	
Membership increasing—editorial comment .....	27	3
Officers and Council 1935-36 (revised) .....	28 136, 137	
Photograph of A. B. Shepard, President .....	28 facing 1	
Photographs of officers .....	27 facing 80, 86, 227	

	VOLUME	PAGE
Dominion Association of Chartered Accountants, The—Continued		
President's visit to institutes .....	29	64
Annual meeting 1936—references thereto .....		
	28 67; 29 1, 2, 87,	88, 251, 313
Address of President Shepard at annual meeting ....	29	209
Meeting of executive committee .....	30	259, 331
Membership in Association brings responsibilities — editorial comment .....	30	449
Officers and Council 1936-37 .....	29	312
Photographs of officers, of Mr. Freeman, of annual meeting .....	29 facing 88,	312, 313
President's visit to Institutes .....	30	487
Reference to Secretary-Treasurer .....	29	147
References to the late Harvey E. Guilfoyle .....	29	317, 319
Representatives of other accounting societies .....	29	313
Annual meeting of 1937—references thereto .....		
	30 421, 487; 31 1, 2, 3,	78, 241, 285
Address of President Winter at annual meeting ....	31	247
Amendment of charter .....	32	396
Meeting of executive committee .....	32	296
Officers and Council .....	31 284; 32 128, 192,	295, 395, 484
Offices of Association .....	31	424
Photographs of officers .....	31 facing 2,	284
Annual meeting of 1938—references thereto .....		
	32 298, 485; 33 1, 2, 3,	89, 90, 173, 245, 303
Annual meeting of 1938—photograph .....	33 facing 386	
Address of President F. A. Nightingale at annual meeting .....	33	251
Delegates of other societies—photographs .....	33 facing 90	
Matters of interest to members ..	33 388, 464; 34 53,	209, 210, 285
Meeting of executive committee .....	34	209, 285
Officers and council .....	33 302, 463; 34 52	
Photographs of officers .....	33 facing 2,	302
President's Christmas greeting .....	33	405
Uniform examinations and a standardized syllabus of education .....	34	209, 285
Annual meeting 1939—references thereto .....	34	289, 448
Dominion of Canada finances .....	32	197
Dominion of Canada, Financial statement of .....	28	68
Dominion—provincial economic relations, J. S. Allely ....	34	202
Double entry thinking, Charles B. Couchman .....	29	368
Double entry thinking needed—editorial comment .....	29	340
Double taxation—editorial comment .....	27	306
"Dust in their eyes"—amusing reference to accountants' reports .....	32	399
<i>Economic Bulletin, The</i> —editorial comment .....	32	323
Economic conditions in Canada—editorial comment ....		
	28 1; 30 2, 282; 31 79; 32 73	
Economic conditions in Canada — Presidential address, A. B. Shepard .....	29	211
Economic council, Repeal of act to establish .....	28	275
Economic design for building, W. A. McKague .....	30	34
Economic—Paths to plenty, H. F. Angus .....	27	40
Economic problems of the prairie provinces, George C. Rooke .....	27	243

	VOLUME	PAGE
Economic recovery in Canada .....	27	359
Economic relations, Dominion-provincial, J. S. Allely ....	34	202
Economic review of 1936, An, J. P. Day .....	30	143
Economic—Some observations on present conditions, Geo. C. McDonald .....	27	34
Economic survey 1936-37, The world—a review by J. P. Day	31	451
Economic—The troubles of Europe, W. A. Mackintosh ....	27	50
Educating our students—editorial comment .....	31	242
Educating our students—What is our responsibility? Kris A. Mapp .....	31	255
Education and examinations, Meeting on—reference there- to .....	33 388, 464; 34	209, 285
Education, Emphasis on—editorial comment .....	34	322
Education, Progress in accountancy—editorial comment ..	34	239
Ellerman name in shipping, The .....	34	213
Embezzler, The typical—editorial comment .....	32	76
Empire spirit—editorial comment .....	34	320
Employment commission, The national .....	29	65
Employment, Increased—editorial comment .....	28	2
England and Wales, Library catalogue of Institute of Char- tered Accountants in .....	30	490
Essay competition, The 1935—announcements .....	27 125, 145, 206; 28	92, 137
Essay competition, The 1936—announcements .....	29 4, 63, 136; 30	9, 61, 452
Essay competition, The 1937—announcements .....	31 7, 49, 123; 32	130
Ethics, Income tax—a problem in, R. W. Hamilton .....	28	118
European trade, [Germany] cornering south-eastern—edi- torial comment .....	34	4
Examination of examinations, An—editorial comment ....	28	230
Examinations a necessary gateway—editorial comment ..	33	406
Examinations—editorial comments .....	29 89; 31	417
Examinations in law, The writing of (by the Examiner) ..	28	378
Examinations of Canada, Accountancy, Austin H. Carr ..	33	362
Examinations, Standardized syllabus for intermediate and final accountancy .....	34	209
Examinations, Supplemental—editorial comment .....	33	407
Examinations, The annual—editorial comment .....	33	406
Examinations, Time limits in—editorial comment .....	33	408
Examination time, Poetic heights at .....	34	367
Exchange control, The new technique of, F. Bradshaw Makin .....	31	94
Exchange Equalization Account—editorial comment .....	34	241
Exchange Equalization Account, The .....	34	266
Exchange, Rate of .....	28	141
Exchequer Court of Canada sittings in Maritimes, The 32	398; 34	369
Exchequer Court of Canada sittings in Western Canada, The .....	33	144
Executors' accounts, On the audit of, W. Gordon Firstbrook	27	8
Executors and trustees, Accounts of, T. A. Morrow ....	28 391; 29	21
Export trade, Importance of—editorial comments .. 28	97, 361; 32	74
Export trade—Obstacles and remedies—editorial comment	32	222
Export trade, Some difficulties of, Walter Lattman .....	32	257
Failures in 1936, Fewer business .....	30	158
Farm costs—editorial comment .....	34	157
Farm products, New uses for—editorial comment .....	28	302
Finance committee, National .....	30	64

	VOLUME	PAGE
Finance, Public, C. A. Curtis .....	34	348
Financial accounts, Improvement in, George O. May ..	53 42, 106,	200
Financial and industrial survey, A, Harold E. Crate ....	28	414
Financial statements, Analysis of, Philip H. Hensel .....	32	27
Financial statements, Further references to auditors' reports and the examination of .....	34	121
Fire destruction losses .....	33	308
Fishing grounds, Canada's .....	27	287
Fixed costs on profits, The effect of, A. S. Hallamore ....	34	17
Food cost accounting, J. R. Hendry .....	31	154
France, The Bank of—editorial comment .....	33	411
Fraudulent practices, Good systems and, C. A. Ellis .....	34	355
Freeman, George R.—reference to .....	29 facing	88, 147, 402
Freight, A method of recording and checking, H. W. Brown	33	450
Fruit growing industry of Nova Scotia, The, T. Harold Johnson .....	27	349
Fruit, Value of commercial .....	33	69
Fund consciousness—A forgotten aspect of commercial accountancy, William Macintosh .....	30	188
Gas industry, Some observations by a newcomer to the, M. W. Waddington .....	33	30
German foreign trade methods—editorial comment .....	34	2
German long-term credit—editorial comment .....	34	5
Gods of the copybook headings, The, Robert England ....	31	346
Gold clause obligations—reference thereto .....	30	360
Gold mining industry .....	31	395
Gold mining industry, Value of—editorial comment ....	28	296
Gold mining (see "Accounting") .....		
Gold, Problems of Britain's, F. Bradshaw Makin .....	32	365
Gold production .....	32	200
Gold, Revaluation of—editorial comment .....	34	242
Gold stores .....	31	290
Gold, The valuation of, J. P. Day .....	30	408
Goodwill, Valuation of—editorial comment .....	30	346
Government, Men of experience in—editorial comment ....	27	229
Government returns, Some thoughts on tax and other, W. F. Holding .....	34	27
Governments, Co-operation between—editorial comment ...	29	423
Governments, How to assist—editorial comment .....	29	253
Government, Some problems as between business and, Kris A. Mapp .....	33	192
Grain exporters and shippers, The financial statements of, Wm. Aitken .....	31	331
Grain trading account, The arithmetic of the, William Macintosh .....	34	326
Great Britain, Profession in—editorial comments .....	32	155, 322
Harvey, Frank M., The late—photograph .....	33 facing	178
Health and vacations—editorial comment .....	39	91
Holding companies accounts, Henry Morgan .....	28	268
Holiday reading—editorial comment .....	29	8
Home improvement loans .....	33	229
Home improvement plan in Canada .....	30	34, 426
Hospital accounting—Departmental analysis, K. E. Greenwood .....	30	24
House construction, Development in .....	28	276
Housing Act, Dominion—editorial comment .....	27	149
Housing and building in Great Britain .....	30	159, 340

	VOLUME	PAGE
Housing and home improvement loans .....	34	131
Housing plan, The Dominion low rental—editorial comment ..	33	174
Hudson's Bay Company, The archives of the, Gordon Briggs ..	32	116
Immigrants .....	28	276
Immigration to Canada during 1936 .....	30	427
Immigration to Canada during 1937 .....	32	397
Improvement in financial accounts—editorial comment ..	33	3
Improvement in financial accounts, George O. May ..	33	42, 106, 200
Income, Measurement of—editorial comment .....	34	148
Income tax (see also "Legal Decisions" and "Taxation")		
Income Tax Act of Ontario 1936, The, R. J. Dilworth ....	28	441
Income tax administration—editorial comments ..	32 426; 34	160, 162
Income tax, Agreement between Canada and the United Kingdom for reciprocal exemption of certain agency profits from .....	27	305, 353
Income tax—A problem in ethics, R. W. Hamilton .....	28	118
Income tax collections by districts 1934-35 .....	27	62
Income tax collections by districts 1935-36 .....	28	437
Income tax collections by districts 1937-38 .....	32	487
Income tax collections by districts, 1938-39 .....	34	368
Income tax, Convention concerning rates of (Canada-United States) .....	30	419
Income tax, Depletion in metal mines for, Stanley B. Laing ..	32	328
Income tax division, The—address of Hon. J. L. Ilsley ....	32	120
Income taxes and succession duties in Canada, Great Britain and the United States, Personal, W. L. Gordon ..	30	397
Income taxes payable in Alberta and Saskatchewan .....	27	115
Income taxes, succession duties and other direct taxes in Canada, the United States and Great Britain, W. L. Gordon .....	32	261
Income tax in Great Britain and Northern Ireland, The administration of the, Roger N. Carter .....	32	466
Income tax law, The administration of the Canadian, C. Fraser Elliott .....	33	268
Income tax legislation, Retroactive—editorial comment ..	28	388
Income tax, Practical schedule for—editorial comment ..	31	152
Income tax, Provision in will to pay — editorial comment ..	34	393
Income tax returns, Filing of .....	32	299
Income tax revenue—Dominion (during 1935) .....	27	287, 430
Income tax revenue—Dominion (during 1936) .....	29	148, 492
Income tax, The collection of (with chart) .....	28	362
Income War Tax Act (See also "Legal Decisions")		
Income War Tax Act amendments—1935—Parliamentary discussion thereon .....	27	24
Income War Tax Act, Amendments of—editorial comment ..	33	95
Income War Tax Act—Decentralized administration—editorial comment .....	32	5
Income War Tax Act, New regulations under the—		
Amended regulations respecting metalliferous mines coming into production—December 1938 .....	34	47
Regulations respecting the filing of consolidated returns—January 1939 .....	34	128
Regulations respecting the maintenance of books and records in Canada—March 1939 .....	34	294
Income War Tax Act, The, G. E. Hayman .....	27	315
Incorporated Accountants and Auditors, The Society of—		
Examination results April and November 1935 ....	27	207; 28 142
Examination results May and November 1936 ....	29	238; 30 159

	VOLUME	PAGE
Industrial relations, Study of—editorial comment .....	31	317
Industry in Great Britain, State aid to .....	33	229
Industry, The advances in—editorial comment .....	31	316
Inflation, Some aspects of currency, F. C. Biggar .....	29	40
Institute of Chartered Accountants in England and Wales— Examination results May 1935; May 1936; November 1937 .....	27 207; 29	238; 32 199
Represented at 1936 annual meeting of the Dominion Association .....	29	147, 402
Roger N. Carter elected president .....	29	238
Insurance and average, Marine, R. W. Gardner .....	34	11
Insurance and suicide, Life—editorial comment .....	33	91
Insurance company, The accounts and audit of a fire, H. B. Clearihue .....	34	401
Insurance companies, Valuation of securities of .....	28	67
Interest rates—editorial comment .....	28	157
Interest, The reaction of life insurance companies to the declining rate of, V. R. Smith .....	28	166
Internal check and its bearing upon the audit programme, The system of, E. H. Banks .....	28	189
Internal check—editorial comment .....	34	246
International accounts, with special reference to Can- ada's balance of international payments, Frank A. Knox .....	29	93, 195 296, 384
International congress on accounting, Fifth—Berlin 1938— references thereto .....	30 488; 31 390; 32 486; 33 465	
International Railway Company v. The Niagara Parks Commission—an accountant's point of view respecting depreciation, G. P. Keeping .....	33	298
Inventories, Accountants certificates and .....	34	199
Inventories, Valuation of—editorial comments .....	32	80, 139, 412
Inventories, Valuation of stock in trade or, F. R. M. dePaula ..	30	466
Inventory control, Retail method of—editorial comment ..	34	228
Inventory control, Retail method of, Philip H. Hensel ....	30	223
Inventory losses by New York Stock Exchange, Treatment of .....	32	301
Inventory valuation and business profits—The case for a "stabilized" basis, Albion R. Davis .....	32	93
Inventory valuation—editorial comment .....	30	92, 449
Inventory values for certain industries, Basic, G. C. Ferrie ..	30	124
Investigating governments—editorial comment .....	28	161
Investment trust administration in Canada, Some aspects of, A. Ian Fleming .....	34	101
Investment trusts, T. Vincent Burke .....	30	19
Investor, Protecting the—editorial comment .....	27	229
Investors developing self-possession—editorial comment ..	33	7
Ireland, The chartered accountants in .....	30	422
Irrigation in Alberta—editorial comment .....	29	255
Irrigation problem in Alberta, The, James L. Kergan ..	29	284
King's English, The .....	34	448
King George VI—references to .....	30	1, 357
King of glorious memory, A—editorial comment .....	28	91
King, Welcome to our—editorial comment .....	34	319
Land settlement scheme .....	28	142
Land settlement to reduce relief rolls, G. R. G. Baker ..	34	443
Land titles—No room for opinion—humorous reference ..	34	213



	VOLUME	PAGE
Law, Money paid under mistake of—editorial comment ..	33	333
Lawyers' accounts, J. Grant Glassco .....	31	19
Legal Decisions—		
Accountants—alleged negligence, an Irish Free State case .....	30	137
Accountants—ownership of working papers— <i>Ipswich Mills v. William Dillon</i> (reference to Massachusetts case) .....	28 384; 34	6
Accountants—ownership of working papers—reference to New York surrogate court case .....	28	383
Accountants—ownership of working papers— <i>Sockockinsky v. Bright, Grahame &amp; Co.</i> (reference to English case) .....	34	7
Assessments—rental (see references to two cases in Winnipeg) .....	31	421
Auditors—alleged negligence— <i>Leech v. Stokes Bros. &amp; Pim</i> .....	31	245
Auditors—duties of — <i>In re S. P. Catterson &amp; Sons, Limited</i> .....	30 281, 326	
Auditors—misappropriation by client's employee — <i>Guardian Insurance Co. v. Sharp, Milne &amp; Co.</i> ....	34	295
Auditors—negligence— <i>Pendleburys Limited</i> case ....	28	298
Bankruptcy — extension agreement — priority of—claims— <i>Nerlich &amp; Co. et al v. Fream</i> .....		
Bankruptcy—false statement to obtain composition— <i>Rex v. Minden et al</i> .....	34	295
Bankruptcy—Farmers' Creditors Arrangement Act—secured credit— <i>Commercial Life Insurance Co. v. Strynadka</i> .....	27	434
Bankruptcy—fees of solicitor for trustee— <i>Re Linton and Sinclair Co. Ltd.</i> .....	32	488
Bankruptcy — non-payment of debts as act of bankruptcy— <i>Re Marcus</i> .....	30	430
Bankruptcy—priority of liens— <i>re General Fireproofing Co.</i> .....	29 145, 325, 31	324 493 126
Bankruptcy — proof and amendment of claims — <i>re Stobie Forlong &amp; Co. &amp; Colwell</i> .....	31	293
Bankruptcy—proxies by trust company— <i>Re Ditchburn Boats and Aircraft Ltd.</i> .....	32	489
Bankruptcy—reorganization of brokerage corporation — <i>Trustee of Stobie Forlong &amp; Co. et al v. Colwell</i> ..	32	488
Bankruptcy—taxes as preferred claim— <i>Re Zimmon</i> ..	29	325
Bankruptcy trustee—rights of—joint insurance policy — <i>Grobstein v. Kouri et al</i> .....	29	324
Banks—joint account— <i>Radway and Shortt v. Radway</i> ..	33	146
Banks—timber contract assigned as security— <i>Royal Bank of Canada v. Port Royal Pulp &amp; Paper Co.</i> ..	34	296
Brokers—conversion of shares— <i>McLaughlin v. Solloway et al</i> .....	29	67
Brokers' marginal transactions— <i>Allen v. O'Hearn &amp; Co.</i> .....	27	306
Chattel mortgages—Bill of sale as security— <i>Sexty v. Agnew</i> .....		
Cheque—pay cash or order— <i>North and South Insurance Corporation</i> case .....	34	132
	28	4

Legal Decisions—Continued	VOLUME	PAGE
Companies—abbreviation of corporate name— <i>Continental Marble Co. v. Langs</i> .....	31	471
Companies—corporate powers— <i>Neily v. Brooklyn Fruit Co.</i> .....	31	293
Companies—directors' liability for wages— <i>Mulligan v. Lancaster et al</i> .....	30	430
Companies—election of directors— <i>Watt v. Commonwealth Petroleum Ltd. et al.</i> .....	34	296
Companies—enforcement of call by directors— <i>Sun Trust Co. v. Begin et al</i> .....	31	472
Companies—false statement in prospectus— <i>Pigott &amp; Pigott Construction Co. v. Nesbitt, Thompson &amp; Co.</i> .....	34	56
Companies—forfeiture of charter by non-user— <i>Dominion Distillery Products Co. v. The King</i> .....	32	400
Companies—issuance of shares at discount— <i>Spooner v. Spooner Oils Ltd.</i> .....	29	326
Companies—issuance of stock in return for services— <i>Waschysyn v. Kildonan Ice &amp; Fuel Co. et al</i> .....	31	126
Companies—misfeasance of director— <i>Trustee of Richards &amp; Co. v. Coulson</i> .....	31	473
Companies—payments of dividends by cheque—forged endorsement— <i>Rands v. Hiram Walker, G. &amp; W. Ltd.</i> .....	29	493
Companies—powers of directors— <i>Export Brewing &amp; Malting Co. v. Dominion Bank</i> .....	31	472
Companies—private limited companies—"just and equitable"— <i>In re Davis and Collett Limited</i> ....	29	6
Companies—recovery of assets by liquidator— <i>Lloyd-Owen v. Bull</i> .....	29	494
Companies—reorganization of insolvent companies— <i>Montreal Trust Co. v. Abitibi Power &amp; Paper Co. et al</i> .....	32	400
Companies—reorganization—rearrangement of stockholders of preferred shares— <i>re Western Grocers Limited</i> .....	29	254, 326
Companies—reorganizations— <i>re Langleys Ltd. and re National Grocers Co. Ltd.</i> .....	32	290; 33 309
Companies—secret profits— <i>Proprietary Mines Ltd. v. Mackay</i> .....	34	56
Companies—shareholders, loans to— <i>The King v. Kus-sner</i> .....	30	56, 264
Companies—transfer of shares concurrent with payment— <i>Beaton v. Cooper</i> .....	32	489
Company in liquidation—rights of shareholders— <i>Ferguson v. Wallbridge</i> .....	27	360
Constitutional law—Dominion Act (Live Stock) <i>ultra vires</i> — <i>re Zaslavsky</i> .....	27	435
Contract—charitable subscription— <i>Provincial Sanatorium v. McArthur</i> .....	27	435
Contracts—agreement not to engage in same business— <i>Maguire v. Northland Drug Co.</i> .....	27	361
Contracts—discharge by sale— <i>Northern Ontario Power Co. v. Laroche Mines Ltd. et al</i> .....	34	132
Coronation cases—reference thereto .....	30	74
Directors' liability for wages— <i>Domanski v. Wilson et al</i> .....	27	435
Dividends paid out of depreciation reserves— <i>The Crow's Nest Pass Coal Company case</i> .....	27	105

Legal Decisions—Continued	VOLUME	PAGE
Executors — accounting — <i>Benjamin et al v. Haskell et al</i> .....	30	264
Executors — action against administrator for loss — <i>Davis v. Auld et al</i> .....	33	146, 311
Executors—allocation of shares as residuary legatee— <i>Wood et al v. Wood</i> .....	34	133
Executors—compensation for services— <i>Re Mortimer</i> ..	29	327
Executors — equitable conversion — compensation as trustee— <i>Re Smith, Re Bell</i> .....	34	370
Executors—power to carry on business— <i>Bank of Montreal v. Morrow</i> .....	29	494
Executors — recovery of taxes paid — <i>Aylesworth v. Toronto</i> .....	29	494
False prospectus— <i>Pepper Pool</i> case .....	28	229, 260, 354
Gold clause obligations—International Trustee, etc. v. Rex .....	30	360
Income tax—annuity chargeable upon corpus of estate —the <i>Whitney</i> case .....	29	232; 30 265
Income tax—assessments—appeal case in Saskatchewan— <i>Re W. H. Kirkaldie</i> .....	29	152
Income tax—bequest or remuneration— <i>The J. M. Mackenzie Estate</i> case .....	29	60, 495; 30 430
Income tax—brewers' "treating expense" not allowed— <i>Riedle Brewery</i> case .....	33	129
Income tax—charitable trust— <i>Peter Birtwistle Trust</i> case .....	32	125, 492; 34 46, 215
Income tax—consolidated returns—profit on returnable containers— <i>Western Vinegars Limited</i> case ..	32	45, 401, 491
Income tax—depreciation on assets fully depreciated— <i>Pioneer Laundry and Dry Cleaners</i> case .....	32	43, 157, 304, 402; 34 45, 214
Income tax—dividends paid from reserve funds (see "Taxing capital distributions")		
Income tax—dividends to non-residents— <i>The King v. Johnson-Matthey &amp; Co.</i> .....	32	389; 33 231
Income tax — estate development company —re <i>John Cronk &amp; Sons, Ltd.</i> .....	27	209
Income tax—exemption — non-residents — re <i>Toronto General Trusts</i> .....	27	436
Income tax—family corporation—re <i>Omer H. Patrick</i> ..	27	425; 28 444; 29 406
Income tax—family settlement—income expended on behalf of settlor— <i>W. H. Malkin</i> case .....	33	217; 34 216
Income tax—husband and wife partnership incomes (see "Income tax—family corporation," above)		
Income tax (Manitoba)—undistributed profits of one company received as dividends by another — re <i>Jackson &amp; Sons</i> .....	30	265
Income tax—monthly payments from life insurance policy— <i>Bessie L. Shaw</i> case .....	34	45
Income tax—New Zealand—stock and goodwill — re <i>Doughty</i> .....	27	210
Income tax—oil royalties — non-deductible expenses— <i>Snyder and Applegate</i> cases .....	33	293; 34 215
Income tax—payment on cessation of office— <i>The C. P. Fullerton</i> case .....	33	462; 34 57

## Legal Decisions—Continued

VOLUME PAGE

Income tax—payment to executor for services (see also bequest or remuneration)— <i>The J. M. Mackenzie Estate</i> case .....	29	60, 495; 30	430
Income tax—payments to estate of deceased partner for use of name— <i>Riddell v. The Minister of National Revenue</i> .....	32	391; 33	310
Income tax—payment to shareholders from a depletion reserve—return of capital— <i>McConkey</i> case .....	31	458; 32	490
Income tax—personal corporation controlled by estate <i>Gilman</i> case .....	31		460
Income tax—personal corporation controlled by executors appointed by will— <i>re Port Credit Realty Co.</i> .....	31		292
Income tax—personal corporation—expenses disallowed—consolidated return—dividend cheque premiums— <i>W. R. Wilson</i> case .....	33	295; 34	296
Income tax—personal corporation—losses—chief business— <i>H. C. Hatch</i> case .....	33	56; 34	215
Income tax—preference shares redeemed at a premium—“undistributed income on hand”— <i>Walter E. H. Massey Estate</i> case .....	34		44
Income tax—premium paid on redemption of capital stock— <i>The Sir Lyman Jones Estate</i> case— <i>National Trust Co. v. Minister of National Revenue</i> .....	28		278
Income tax—Provincial income tax on Dominion employees— <i>Forbes v. Attorney General of Manitoba</i> .....	30		431
Income tax (Saskatchewan) — extra-provincial company—“carrying on business” within the province— <i>re Proctor and Gamble Company of Canada</i> .....	32	47; 33	68, 147
Income tax (Saskatchewan)—liability of judges to pay .....	31		127
Income tax—stock dividends— <i>Johnson-Matthey &amp; Company</i> case .....	32	389; 33	231
Income tax—transfer of property on marriage contract— <i>re Molson</i> .....	31	218; 32	490
Income tax—unclaimed balances part of profits— <i>Inspector of Taxes v. Tattersalls</i> [English case] ....	34		54
Insurance—failure to disclose previous refusals— <i>re Chopowich</i> .....	27		436
Insurance—partnership property — <i>Re Cumming &amp; Emery</i> .....	27		211
Insurance—policy assigned as security— <i>re Armstrong</i> .....	33		147
Interest on bonds—“working expenditures”— <i>re Moose Jaw Electric Railway Company</i> .....	28		278
Loose leaf minute books— <i>Hearts of Oak Assurance Company</i> case .....	28	5, 227,	273
Marketing— <i>The Natural Products Marketing Act</i> ....	29		495
Municipal debentures—moratorium— <i>Day v. Victoria</i> ..	34		133
Negligence—aircraft operation — <i>McInnery v. McDougall</i> .....	32		49
Partnership—liability of father and son— <i>Fancy v. Whynot et al</i> .....	34		133
Partnerships—reference to English court case .....	34		324
Premium paid on redemption of preference shares— <i>Estate of Sir Lyman Jones</i> case .....	27		195
Profits—share in profits additional to wages— <i>Bussieres v. Canadian Exploration Company</i> .....	32		201

## Legal Decisions—Continued

VOLUME PAGE

Profits—share of in payment of business— <i>re Ramsey</i> (England) .....	29	339
Promissory note—signature on face beneath maker— endorser— <i>Boisvert v. Lavalee et al.</i> .....	27	211
Promissory notes—illegal consideration — <i>Prudential</i> <i>Exchange v. Edwards</i> .....	32	201
Promissory notes—presentment and default— <i>re Cor-</i> <i>poration Securities Limited</i> .....	27	212
Sales tax — claims for refund — <i>Dominion Distillery</i> <i>Products Co. v. The King</i> .....	34	58
Sales tax—dresser and dyer of furs— <i>Hollander &amp; Son</i> <i>v. The King</i> .....	28	279
Sales tax—"Goods manufactured and produced"— <i>re</i> <i>Boulbee Ltd.</i> .....	33	312
Sales tax—limited companies controlled by same per- son— <i>Re B. C. Brick &amp; Tile Co.</i> .....	29	405
Sales tax—old tires retreaded— <i>Re Bilrite Tire Com-</i> <i>pany</i> .....	31	471
Sales tax—property and civil rights— <i>re Imperial To-</i> <i>bacco Company of Canada, Limited</i> .....	33	312
Sales tax — separate companies — manufacturing ar- rangement— <i>Lapointe v. J. T. Wait Co. &amp; Crystal</i> <i>Products Co.</i> .....	34	134
Service charge—expenses incurred on loan— <i>Discount</i> <i>&amp; Loan Corporation v. Superintendent of Insurance</i> .....	34	58
"Solvency"—a matter of terminology .....	31	6
Stock dividends as "usufruct"— <i>Laverdure v. du Trem-</i> <i>blay et al.</i> .....	31	127
Succession duties—extending time for payment — <i>re</i> <i>Drummond</i> .....	29	495
Succession duties—gift <i>inter vivos</i> — <i>re Boyd</i> .....	32	132
Succession duties—gifts through corporation — <i>Re</i> <i>Meitcke et al.</i> .....	32	202; 33 231
Succession duties—personal property given away dur- ing life— <i>re Fasken</i> .....	27	361
Succession duties— <i>re Moore</i> .....	31	473
Succession duties—valuation of hotel property (British Columbia case) .....	31	127
Succession duty—company shares—owner domiciled in another province— <i>Toronto General Trusts v. The</i> <i>King</i> .....	32	132
Succession duty on deposit receipt—situs of debt— (Manitoba case) .....	31	127
Taxation—agreement to exempt land from taxation— <i>Tellier v. St. Hyacinthe</i> .....	28	279
Taxation—Direct taxation within province— <i>re Kerr</i> .....	33	232; 34 297
Taxes—appeal from decision of Railway and Municipal Board— <i>Re Famous Players Canadian Corporation</i> .....	29	327
Taxes—application for refund of taxes paid— <i>re Ontario</i> <i>Jockey Club</i> .....	27	362
Taxes—assessment for income—holding company— <i>In-</i> <i>ternational Metal Industries Ltd. v. Toronto</i> .....	34	371
Taxes—assessment for income—profit from invest- ments—interest on loans to subsidiaries— <i>The</i> <i>Mining Corporation of Canada Ltd. v. Toronto</i> ....	34	372
Taxes—assessment of income taxes on mining com- panies (Ontario)— <i>Teck v. Hayward et al.</i> .....	29	328
Taxes—business tax on chain store property—repair shop— <i>re Loblaw Groceries Co.</i> .....	29	406

Legal Decisions—Continued	VOLUME	PAGE
Taxes—business tax— <i>National Trust Co. v. City of Winnipeg</i> .....	31	474
Taxes—claim for return of taxes paid— <i>re Eraut</i> .....	27	212
Taxes—income derived from subsidiary companies— <i>re Famous Players Canadian Corporation</i> .....	27	362
Taxes—income taxes in Quebec—temporary abode— <i>Montreal v. Jacobs</i> .....	29	496
Taxes — refund when not legally due — <i>Walkerville Brewery Ltd. v. The King</i> .....	34	58
Taxes—shareholders and company as “co-owners”— <i>Flood v. Monargo Mines Ltd.</i> .....	32	491
Taxes—succession duty on deposit receipt— <i>re Bennett</i> .....	29	496
Taxes—unearned increment— <i>re Northern Agency Ltd.</i> .....	32	491
Taxes—valuation for business tax— <i>Newton &amp; Co. v. City of Winnipeg</i> .....	31	474
Taxing capital distributions—( <i>The Crow's Nest Pass Company case</i> )— <i>Northern Securities Company v. The King</i> .....	28	93, 278
Trade, In restraint of— <i>Canadian Linen Co. v. Mole</i> ..	31	422
Trustees—discretionary power—conversion— <i>re Gilroy</i> ..	33	148
Trustees—use of trust funds to reduce trustees' debt to bank— <i>McPherson v. Dominion Bank</i> .....	28	444
Trustees—voting trust— <i>re Firstbrook Boxes Limited</i> ..	29	67
Trusts — intermingling of trust funds — prior lien of trust creditors— <i>Re Saskatchewan General Trusts Corp. Ltd.</i> .....	34	134
Wills—accumulated income as intestacy— <i>re Hammond</i> ..	27	436
Wills—annuities—income from fund— <i>re Gilroy</i> .....	32	133
Wills—charge upon estate—income taxes— <i>re Kemp</i> ..	34	371, 393
Wills — charitable trust — corporate powers — <i>Re Galbraith</i> .....	34	370
Wills—construction—time of vesting— <i>re Magee</i> .....	27	212
Wills—deceased child as beneficiary— <i>re Rake</i> .....	32	202
Wills—lost will— <i>Sigurdson v. Sigurdson</i> .....	28	445
Wills—right to delay conversion— <i>re Gage</i> .....	33	232
Legislation, Some recent Dominion .....	30	417
Leisure, Baron Tweedsmuir (John Buchan) .....	28	47
Life assurance companies, Annual statements of—reference thereto .....	30	278, 424
Life insurance companies, The financial records and statements of, William G. Leonard .....	30	364
Life insurance companies to the declining rate of interest, The reaction of, V. R. Smith .....	28	166
Life insurance statements—editorial comment .....	31	420
Life insurance statements to the public, Presenting, V. R. Smith .....	31	442
Loans, Home improvement .....	33	229
Loans, Housing and home improvement .....	34	131
Loose-leaf minute books—a court case .....	28	5, 227, 273
Management Congress, International .....	33	145
Management engineering—Prepare to-morrow's statements today, Paul Kellogg .....	34	273
Management, Responsibilities of auditors and of—the <i>Interstate Hosiery</i> case—editorial comment .....	34	398
Manitoba, Fiftieth anniversary of Institute of Chartered Accountants of .....	28	295, 364; 29 68
Manitoba's natural resources, Developing .....	34	366
Marine insurance and average, R. W. Gardner .....	34	11

	VOLUME	PAGE
Maritime Provinces—editorial comment .....	33	247
Maritimes, Regional meeting in the—editorial comment ..	31	314
Marketing schemes (Dominion)—editorial comment .....	27	146, 385
May, The month of—verse .....	34	365
McDonald, George C.— <i>Honoured</i> .....	31	288
McKesson & Robbins case—editorial comment .....	34	91
Members of profession, New—editorial comment .....	32	153
"Mental gymnastics" .....	28	143, 208
Mine development, Encouraging—editorial comment .....	28	296
Mines coming into production, Metalliferous—departmental ruling (February 1937) .....	30	338
Mining companies, Accounting for gold, G. C. Andrew ....	28	236, 360
Mining companies, Dividends of Canadian .....	32	49
Mining companies prior to production, Accounting system for gold, Frank Willcox .....	28	316
Mining companies, Some thoughts on taxation of, H. Wyburn George .....	34	92
Mining companies with capitalization not exceeding \$35,000 (Ontario) .....	31	464
Mining development, Effect of taxation on—editorial comment .....	27	85
Mining development, Government encouraging — editorial comment .....	30	283
Mining industry in Canada—nickel .....	30	427
Mining policy, Government's—editorial comment .....	28	387
Misconceptions, Some popular—editorial comment .....	29	343
Monetary misconceptions, F. C. Biggar .....	30	39
Money paid under mistake of law—editorial comment ....	33	333
Mortgage loan company, Accounts of a, Irvin T. Hunt ....	32	428
Motor transport, Government regulation of, M. L. Rapoport ..	29	290
Municipal accounting and auditing, A. B. Shepard .....	28	50
Municipal accounts, Audit of—a Quebec case .....	27	202
Municipal accounts in the Province of Quebec, Audit of ..	34	292
Municipal administration .....	32	197
Municipal audit specialized—editorial comment .....	32	3
Municipal balance sheet, The capital account section of a, Wm. S. Tory .....	29	175
Municipal budgeting with respect to urban municipalities, George F. Cameron .....	30	458
Municipal councils, Choice of auditors by—editorial comment .....	30	186
Municipal debt administration .....	28	65
Municipal defaults in Alberta, Few .....	28	275
Municipal finance, J. A. Towner .....	32	170
Municipal Finance Officers' Association—annual conference 1936 .....	29	149
Municipalities, Legislation affecting Ontario, Harold A. Shlach .....	28	438
Municipalities—Local borrowing in England—editorial comment .....	32	424
Municipalities with respect to unnegotiated debentures and debenture principal and interest in default, Accounting for, W. S. Tory .....	28	104
Municipal officers' code of ethics—editorial comment .....	32	4
Municipal tax arrears in the Province of Quebec, Consolidation of .....	31	54
Municipal treasurers, Defalcations of — editorial comment ..	32	1
National service, Accountants and—editorial comment ....	34	163

	VOLUME	PAGE
Natural business year—reference thereto .....	30	5
Natural business year, The—editorial comments .....	28 7; 34	85
Negligence, Case of alleged ( <i>Leech v. Stokes Bros. &amp; Pim</i> )— editorial comment .....	31	245
Newspaper accounting, Oscar H. Harder .....	29	9
New Zealand Accountants .....	31	395
New Zealand Society of Accountants .....	34	55
Nickel in coinage .....	27	432
Nova Scotia, Economic council for .....	28	70
Nova Scotia fisheries .....	29	149
Obituaries—C. W. Baker .....	29	409
J. Wilfred Boulet .....	33	314
William S. Buttar .....	33	314
William Robert Carmichael .....	30	342
E. V. Chaplin .....	27	215
Arthur Craig .....	33	475
Alfred James Doggerell .....	32	403
Andrew F. Dowie .....	31	220
Charles Sheppard Eddis .....	27	86
W. G. Firstbrook .....	30	161
Alexander Frederick Falls .....	34	222
Arthur Clifford Foote .....	34	223
Alexander Whyte Goldie .....	30	162
Harvey Edward Guilfoyle .....	27 312,	364
Frank M. Harvey .....	33	233
Charles A. Hodgson .....	31	132
Arthur Edward Middleton Hope .....	27	71
Hugh Howat .....	34	369
John Hyde .....	30 8, facing	10
J. Porter Joplin .....	34	222
Samuel N. Jordan .....	31	402
Robert K. Laidlaw .....	34	142
Arthur T. Lawson .....	31	132
J. C. M. Ligertwood .....	29	240
George Loos .....	27	215
Homer L. Lord .....	31	61
Wilson Anderson Loudon .....	28	10, 75
S. C. Lowthian .....	29	240
Preble Macintosh .....	34	450
William Mattocks .....	28	282
John T. McArthur .....	27	215
Arthur Clifton Neff .....	28	233
Angus McColl Parker .....	30	268
Sir William Barclay Peat .....	28	164
Alexander Cruickshank Rattray .....	28	145
Cyril B. Rawlins .....	28	10, 75
Charles A. Ritchie .....	31	61
A. Scott Robertson .....	27	71
John Wesley Rosborough .....	32	403
John Bulmer Rutherford .....	27	365
Thaddeus I. Seburn .....	27	364
James D. Small .....	34	142
J. H. Stagg .....	30	161
George Ussher Stiff .....	32	495
Herbert R. Thompson .....	31	61
Sir George A. Touche .....	27	133
Richard Osler Wade .....	27	134
Charles E. White .....	31	61



	VOLUME	PAGE
Obituaries—Continued		
Archibald Woods .....	33	475
Sir Albert William Wyon .....	32	56
Obsolescence, The burden of, William H. Wynne .....	30	312
Occupational exchange of population with United States..	31	291
Office machines, Research of .....	30	491
Officialism [in government] works, How—editorial comment .....	34	160
O.K., Meaning of .....	27	208
Oil refinery, The accounts of a small, Milton Howard ....	34	247
Oil royalties in Alberta, William F. Reid .....	33	9
Ontario notes—re small mining companies; Business tax refunds 1936 .....	31	464
Ontario—The distribution of corporate assessments for school purposes, G. R. G. Baker .....	29	150
Our profession—Quo vadis? H. G. Norman .....	33	335
Parliament, Representatives in—editorial comment .....	28	97
Parliament shirking its responsibilities—editorial comment	34	159
Partnership incomes, Husband and wife—a judgment of the Exchequer Court .....	27	425
Partnerships, <i>De facto</i> —editorial comment .....	34	324
Parton, John—Reference to passing of Mrs. Parton .....	32	129
"Pay cash or order"—a court case—editorial comment ....	28	4
Peace and thanksgiving—editorial comment .....	33	329
Pepper Pool case, The—A fraudulent prospectus conviction .....	28 229, 260,	354
Perseverance, The reward of—editorial comment .....	30	451
Personals .....	27 70, 132,	291
	28 74, 281, 365,	447
	29 75, 161, 328,	408
	30 267, 342,	433
	31 60, 132,	474
	32 54, 134, 205, 308,	495
	33 74, 156, 313,	393
	34 62, 138, 301,	375
Population with United States, Occupational exchange of ..	31	291
Position of the public accountant in relation to business and government in Great Britain, The, Sir L. Halsey ..	33 373,	434
Prairie provinces, Economic problems of the, Geo. C. Rooke ..	27	243
Prairie provinces, Outlook in—editorial comments .....	31 79,	244
Prairie provinces, The—their vastness—editorial comment ..	27	81
Prairies, Our duty to the, M. E. Nichols .....	31	267
Preference shares, Treatment of premium paid on redemption of —a court case .....	27	195
Preferred shares, Holders of—court dismisses application under section 122 of the Dominion <i>Companies Act</i> ....	29 254,	326
Prejudice destructive of sound judgment—editorial comment .....	29	341
President passes on, A former .....	33 facing	178
Price discrimination .....	27	433
Price maintenance, Resale—editorial comment .....	33	94
Private and public enterprise—editorial comment .....	28	160
Private limited companies—editorial comment .....	29	6
Privy council, Judicial committee of—origin .....	27 233,	270
Professional conduct, Rules of—editorial comment .....	27	386
Professional fees—Payment by results—editorial comment ..	27	387
Profession as others see it, The—editorial comment .....	27	83
Profession in the United States, Problems of the, Edwin H. Wagner .....	31	320

	VOLUME	PAGE
Profession in the United States, The, William C. Heaton	33	351
Profession in United States, Growth of—editorial comment	31	81
Profession—Is there overcrowding?—editorial comment ..	32	155
Profession not static—editorial comment .....	29	3
Profession—Principles of organization—editorial comment	31	3
Profession—The needs of tomorrow—editorial comment ..	27	6
Profit on instalment sale—editorial comment .....	32	211
Profit or income "realized"—editorial comment .....	29	411
Profits, A question of realized, J. T. Gow .....	33	60
Profits, A question of "realized" (reference to British court case)—editorial comment .....	32	425
Profits in part payment of business, Share of—editorial comment .....	29	339
Profits, The effect of fixed costs on, A. S. Hallamore .....	34	17
Prospectuses of public companies — Behind the scenes, James Kilpatrick .....	32	237
Provincial News—Alberta .....	27 63, 126, 289, 363, 437	
	28 71, 209, 280, 364, 446	
	29 154, 496	
	30 492	
	31 56, 128	
	33 69, 149, 392, 468	
	34 59, 297	
British Columbia .....	27 64	
	28 71, 143, 446	
	30 69, 432	
	31 56, 219	
	32 50, 305, 493	
	33 70, 150, 392, 468	
	34 60, 135, 298, 373	
Manitoba .....	27 128, 213	
	28 71, 364	
	29 68, 156, 497	
	30 69	
	31 57, 129, 396	
	32 133	
	33 152, 469	
	34 217, 374, 449	
New Brunswick .....	28 72, 365	
	29 74, 407	
	30 432	
	31 398	
	34 217, 374	
Nova Scotia .....	27 128, 290, 363	
	28 447	
	29 74, 239, 407	
	31 130, 398	
	32 50	
	34 218	
Ontario .....	27 65	
	28 209, 438	
	29 150, 158	
	30 69, 266, 341	
	31 131, 401	
	32 203, 306	
	33 154	
	34 136, 218	

Provincial News—Continued		VOLUME	PAGE
Prince Edward Island ...	29		407
	31		398
	33		155
Quebec .....	27	65, 214,	437
	28	72, 143,	280
	29		159, 239
	30		70, 432
	31		57
	32		51, 205
	33		70, 470
	34		61, 136
Saskatchewan .....	27		69, 131
	28		144, 280
	29	75, 152,	159
	30		161
	31		59, 219
	32		134, 493
	33	155, 230,	471
	34		138, 300
Provincial sales tax, A. E. C. Shaughnessy .....	33		179
Public accounts of Canada, The, George C. McDonald .....	30		377
Publications received .....	27 216; 28 146; 29 161, 500; 30 434;		
	31 403; 32 206; 33 471		
Public debt and tax systems, Bulletin on Canadian .....	33		390
Public debts of Canada—editorial comment .....	34	86,	240
Public finance, C. A. Curtis .....	34		348
Publicity, The light of—editorial comment .....	28		160
Public office, Accountants in—editorial comment .....	33		332
Public service in a democracy, Hon. J. L. Ilsley .....	33		343
Public utility company, Some problems of accounting in a gas or electric, G. Meredith Smith .....	28		179
Purchasing power? What is—editorial comment .....	32		225
Quebec notes—Audit of municipal accounts .....	34		292
Quebec notes—Moratorium Act of 1936 .....	30		67
Railway passenger travel—editorial comment .....	29		91
Railway passenger travel, J. L. McDougall .....	29		127
Real estate—problem re repossessed property .....	32		135
Real estate taxes, The incidence of, George R. G. Baker ..	32		443
Relief since 1930, Federal government .....	33		68
Relief rolls, Land settlement to reduce, G. R. G. Baker ..	34		443
Report writing, J. Fulton Camelford .....	28		12
Report writing, Standards in—editorial comment .....	32		325
Research studies—editorial comment .....	33		247
Reserves, Some academic doubts about secret, Ronald S. Edwards .....	29		479
Return on common stocks, The—editorial comment .....	33		178
Revenue, Dominion .....	27		62
Richardson retires, A. P. .....	29		492
Robinson Crusoe, bookkeeper, A. W. Currie .....	30		110
Rowell Commission appointed .....	31		281
Royal Mail Steam Packet Company—editorial comment ..	29		170
Russian unified state budget .....	30		428
Russia, Raising capital in—editorial comment .....	30		362
Russia shipping gold .....	30		428
Sales tax, A provincial, E. C. Shaughnessy .....	33		179
Salmon canning and branch accounting principles as ap- plied to salmon cannery accounts, L. R. Sinclair .....	33		284

	VOLUME	PAGE
Saskatchewan and Alberta, A summary of the reports of the royal commissions on the natural resources of .....	27	188
Saskatchewan, The Province of, Montague W. Kynch .....	31	273
Scientific management .....	30	490
Scottish chartered accountants .....	30	340
Service, The meaning of—editorial comment .....	30	450
Shareholders, Loans to—case of <i>The King v. Kussner</i> ....	30	56
Shaw, W. H., passes .....	34	130
"Shinplaster" issue discontinued .....	27	207
Shipping companies, Changed conditions for—editorial comment .....	29	171
Shoe manufacturing business which operates its own retail outlets, Costing and control in a, Rutherford William-son .....	32	81
Shoe manufacturing industry, The, Alex E. Pierce .....	27	418
Sinking fund, Subsidiary records of bonded indebtedness and relative, V. Randolph Clerihue .....	27	390
Smith honoured, President Sidney Earle (University of Manitoba) .....	30	489
Social credit—editorial comment .....	27	230
Social credit, James C. Thompson .....	30	115, 247
Social insurance .....	27	434
Social welfare agency, Suggested system for a, Milton Howard .....	31	39
Solicitors' rules respecting accounts .....	30	151
"Solvency," The meaning of—a matter of terminology ...	31	6
Some observations on present conditions, Geo. C. McDonald ..	27	34
South Africa, The profession in .....	32	399
South Africa, The profession in—editorial comment .....	30	181
Soviet financial system, The, D. C. Macgregor .....	31	173
Specialize, The right to, R. W. Hamilton .....	29	190
Standard costs, A budget procedure through .....	27	330
State aid to industry in Great Britain .....	33	229
Statistical control of business activities, The, Philip H. Hensel .....	32	177
Steel industry, Promising developments in Canada's ....	33	391
Stiff, The late George Ussher—editorial comment .....	32	427
Stock brokers' accounts .....	34 64, 143, 223, 303, 376,	450
Stock brokers' accounts—editorial comment .....	34	8
Stock dividends—editorial comment .....	34	70
Stock exchange audits, Public service in, W. E. Dunton ..	27	256
Stocks, The return on common—editorial comment .....	33	178
Stores, The control and valuation of, Cecil A. Ellis .....	31	425
Students' Department .....	27 72, 136, 217, 296, 367,	442
.....	28 77, 147, 212, 283, 366,	448
.....	29 76, 162, 241, 330, 411,	501
.....	30 74, 165, 269, 346, 435,	493
.....	31 66, 140, 227, 301, 408,	483
.....	32 61, 139, 211, 312, 412,	498
.....	33 79, 161, 238, 315, 397,	479
.....	34 70, 148, 228, 308, 381,	455
Students' organization in Quebec—editorial comment ....	27	383
Students' society of London—references thereto .....	27	3, 384
Succession duties—1937 amendments Ontario Succession Duty Act .....	31	121
Systems and fraudulent practices, Good, C. A. Ellis .....	34	355
Tariff—Arbitrary valuation of British goods .....	27	431
Tax and other government returns, Some thoughts on, W. F. Holding .....	34	27

	VOLUME	PAGE
Tax appeals are rare, Why—editorial comment .....	34	162
Taxation and the national income—editorial comment ....	28	95
Taxation, Dominion and provincial, New legislation respecting		
Alberta—	1935 amendments .....	27 121
	1936 amendments .....	29 235
	1937 amendments .....	31 114, 463
	1938 amendments .....	33 221
British Columbia—	1935, 1936, 1937 (no amendments)	
	1938 amendments .....	34 42
Dominion—	1935 amendments .....	27 58
	1936 amendments .....	29 137
	1937 amendments ..	30 417; 31 114
	1938 amendments .....	33 139
Manitoba—	1935 (no amendments)	
	1936 .....	29 236
	1937 .....	31 115
	1938 .....	33 222
New Brunswick—	1935 (no amendments)	
	1936 amendments .....	29 310
	1937 amendments .....	31 116
	1938 amendments .....	33 223
Nova Scotia—	1935 amendments .....	27 278
	1936 amendments .....	29 310
	1937 amendments .....	31 117
	1938 (no amendments)	
Ontario—	1935 amendments .....	27 204
	1936 amendments ....	28 438; 29 310
	1937 amendments .....	31 117
	1938 amendments .....	33 224
Prince Edward Island—	1935 (no amendments)	
	1936 amendments .....	29 311
	1937 amendments .....	31 119
	1938 amendments .....	33 225
Quebec—	1935 amendments .....	27 124
	1936, 1937 (no amendments)	
	1938 amendments .....	33 227
Saskatchewan—	1935 amendments .....	27 205
	1936 amendments .....	29 237
	1937 amendments .....	31 120
	1938 amendments .....	33 227
Taxation for school purposes, W. C. Keirstead .....	30	129
Taxation in Manitoba, Mining, J. P. de Wet .....	32	338
Taxation, Memorandum respecting provincial (Quebec) ..	32	474
Taxation, No increase in rates of 1937 (Dominion) .....	30	339
Taxation of mining companies, Some thoughts on, H. Wyburn George .....	34	92
Taxation overdone—editorial comment .....	27	84
Taxation, Property—editorial comment .....	32	421
Taxation, Quebec corporation—editorial comment .....	32	427
Taxation, The profession and—editorial comment .....	27	388

	VOLUME	PAGE
Taxes—re refunds of business taxes paid by income tax-payers to Ontario municipalities in 1936 .....	31	464
Taxes, The incidence of real estate, G. R. G. Baker .....	32	443
Tax evasions, Accountants and—editorial comment .....	33	176
Taxing capital distributions ( <i>The Crow's Nest Pass Company</i> case)—editorial comment .....	28	93
Taxing powers, Provincial—reference to judgments of Supreme court of Canada .....	32	383
Taxpayers, Complacent—editorial comment .....	34	90
Tax problem, A study of the—editorial comment .....	30	453
Tax provisions promote inefficiency? Why should — editorial comment .....	30	4
Tax returns, "Incidence" of (reference in <i>The Saturday Evening Post</i> ) .....	32	131
Tax systems, Bulletin on Canadian public debt and .....	33	390
Terminology department .....	31 62, 136, 221, 294, 404, 476	
	32 57, 208, 309, 409	
	33 75, 159, 235, 394, 476	
	34 67, 145, 225, 306, 378, 453	
Terminology department—editorial comment .....	31	5
Terminology is different, Accounting—humorous reference .....	34	212
Thanksgiving, Season of—editorial comment .....	31	315
Trade and prosperity, Expanding—editorial comment ....	31	423
Trade agreements, Reciprocal—editorial comment .....	33	411
Trade, Canadian foreign .... 27 63, 431; 28 361; 29 149, 492; 30 63, 284		
Trade—economic and financial factors—editorial comment .....	32	222
Trade methods, German foreign .....	34	2
Trade, Removing barriers to—editorial comment .....	27	389
Trade restrictions, Removing—editorial comment .....	28	159
Trade with South Africa, Canadian (1935) .....	28	361
Training and education—editorial comment .....	27	5, 228
Train and education, Sidney E. Smith .....	27	235
Trust company accounting, M. W. Waddington .....	31	366
Trustees in bankruptcy, Licensing .....	33	308
Trustees in bankruptcy and secured and preferred creditors, Lewis Duncan .....	29	145
Trust funds, Safeguarding—references thereto .... 30 95, 151, 263, 423		
Trusts, Fixed and flexible—editorial comment .....	33	5
Truths, Some homely—editorial comment .....	27	3
Turnover tax—editorial comment .....	27	232
Tweedsmuir, Lord—reference to address of—on Bible—editorial comment .....	32	326
United States, Liabilities of accountants under Securities Act of 1933 of .....	29	135
United States, Problems of the profession in the, E. H. Wagner .....	31	320
United States, The profession in the, William C. Heaton ..	53	351
University accounting, Some problems of, J. E. Brower ....	28	304
War debt instalments .....	30	64
War debts, Background of the—editorial comment .....	34	245
War debts, Britain's unpaid—editorial comment .....	34	243
War, Some of the consequences of .....	33	391
Wheat a boon, Rust-proof—editorial comment .....	28	2
Wheat, Export of Canadian .....	27	208
Wheat, Future prospects of—editorial comment .....	32	224
Wheat pools; 1929-1936, The Canadian, Arthur I. Bloomfield	30	232
Wheat problem, Canada's, G. R. G. Baker .....	34	270

	VOLUME	PAGE
Wheat problem, The background of the, H. C. Grant ....	27	153
Wheat production costs, R. W. Gardner .....	34	165
Wills and executorships in the Province of Quebec, W. Roy Dillon .....	31	86
Wills—Disinheritance of dependents by testator—editorial comment .....	31	149
Working papers, Accountant's—editorial comment .....	28 383; 34	6
World Calendar, The—editorial comment .....	28	163
World commerce—editorial comment .....	34	94
World unemployment .....	27	360
Writers, Alberta Institute to encourage .....	33	144
Youth training .....	32	125

## CONTRIBUTORS

	VOLUME	PAGE
Abrams, George, <i>Depreciation charges on the basis of business volume</i> .....	27	344
Aitken, William, <i>The Financial statements of grain exporters and shippers</i> .....	31	331
Allely, John S., <i>Dominion-Provincial economic relations</i> ..	34	202
Andrew, George C., <i>Accounting for gold mining companies</i> ..	28	236, 360
Angus, H. F., <i>Paths to plenty—Economics</i> .....	27	40
Ashley, C. A., <i>The auditor's report to the shareholders</i> ....	34	118
—see also "Book Reviews" .....	29	499; 34 301
Ashmore, M. L.—see "Book Review" .....	30	71
Baker, G. R. G., <i>Canada's wheat problem</i> .....	34	270
— <i>Land settlement to reduce relief rolls</i> .....	34	443
— <i>Recent Alberta legislation</i> .....	29	321
— <i>The distribution of corporate assessments for school purposes—Ontario</i> .....	29	150
— <i>The effect of debt legislation</i> .....	33	213
— <i>The incidence of real estate taxes</i> .....	32	443
Banks, E. Harold, <i>Control exercised through the medium of the budget</i> .....	30	285
— <i>The system of internal check and its bearing upon the audit programme</i> .....	28	189
—see also "Book Review" .....	30	72
Biggar, F. C., <i>Monetary misconceptions</i> .....	30	39
— <i>Some aspects of currency inflation</i> .....	29	40
Bloomfield, Arthur I., <i>The Canadian wheat pools; 1929-1936</i> ..	30	232
Bowman, F. A., <i>Accounting for depreciation in telephone work</i> .....	29	112
Boyter, J. B.—see "Book Review" .....	30	434
Briggs, Gordon, <i>The archives of the Hudson's Bay Company</i> ..	32	116
Brower, J. E., <i>Some problems of university accounting</i> ....	28	304
— <i>The accountant and industrial and public relations</i> .....	31	8
Brown, H. W., <i>A method of recording and checking freight</i> ..	33	450
Burke, T. Vincent, <i>Investment trusts</i> .....	30	19
Camelford, J. Fulton, <i>Report writing</i> .....	28	12
Cameron, Geo. F., <i>Municipal budgeting with respect to urban municipalities</i> .....	30	458
Cameron, James C., <i>A study of costs in the packing industry</i> .....	28	428
Carr, Austin H. (Editor, THE CANADIAN CHARTERED ACCOUNTANT)		
— <i>Editorial comment</i> .....		
— <i>Accountancy examinations of Canada</i> .....	33	362
— <i>Progress in accounting</i> .....	33	121
Carter, Roger N., <i>The administration of the income tax in Great Britain and Northern Ireland</i> ..	32	466
Chambers, E. J., <i>Alberta legislation relative to adjustment and reduction of debts</i> .....	29	470
Chan, Stephen, <i>The supervision of accountants' reports</i> ....	34	261
Charlesworth, J. L., <i>Centralized control and decentralized management</i> .....	29	29
Chown, W. F., <i>Other aspects of agricultural accounting</i> ..	28	334
Clearihue, H. B., <i>The accounts and audit of a fire insurance company</i> .....	34	401
Clapperton, H. D.—see "Book Reviews" .....	27	440; 34 139



	VOLUME	PAGE
Clerihue, V. Randolph, <i>Accounting for revenue of time sales financing companies</i> .....	30	476
— <i>Subsidiary records of bonded indebtedness and relative sinking fund</i> .....	27	390
— <i>The accounts of an automobile distributor</i> .....	31	353
Close, John F., <i>Some problems for the accountant in Russia today</i> .....	28	99
Cochrane, Geo. C., <i>An address on the accounting profession</i> .....	53	262
— <i>Some observations on the profession</i> .....	34	110
Cotter, W. H.,—see "Book Review" .....	32	406
Couchman, Charles B., <i>Double entry thinking</i> .....	29	368
Crate, Harold E., <i>A financial and industrial survey</i> .....	28	414
Crocombe, F. R.,—see "Book Review" .....	30	164
Currie, A. W., <i>Robinson Crusoe, bookkeeper</i> .....	30	110
Cutforth, A. E., <i>Balance sheets, their use, abuse and limitations</i> .....	30	202
Curtis, C. A., <i>Public finance</i> .....	34	348
Dalglish, K. W., <i>Should the statutory form of the auditor's report to the shareholders be changed?—summary of round table discussion</i> .....	53	453
Davidson, M. B., <i>Accounting system for a subscription book company</i> .....	32	8
Davis, Albion R., <i>Inventory valuation and business profits—The case for a "stabilized" basis</i> .....	32	93
Day, J. P., <i>An economic review of 1936</i> .....	30	143
— <i>Currency stabilization</i> .....	29	450
— <i>The valuation of gold</i> .....	30	408
— <i>The world economic survey 1936-37—a review</i> .....	31	451
dePaula, F. R. M., <i>Valuation of stock in trade or inventories</i> .....	30	466
de Wet, J. P., <i>Mining taxation in Manitoba</i> .....	32	338
Dillon, W. Roy, <i>Wills and executorships in the Province of Quebec</i> .....	31	86
Dilworth, R. J., <i>The Companies Act, 1934 (Dominion) and the amendments of 1935</i> .....	27	408
— <i>The Income Tax Act of Ontario 1936</i> .....	28	441
Doe, Gilbert A., <i>Revenue and expense statistics in a brokerage office</i> .....	31	212
Duncan, Lewis, <i>Trustees in bankruptcy and secured and preferred creditors</i> .....	29	145
Dunning, Hon. C. A., <i>Currency and credit in Canada</i> .....	32	341
Dunton, W. E., <i>Public service in stock exchange audits</i> ..	27	256
Easterbrook, W. T.,—see "Book Review" .....	33	78
Edwards, Ronald S., <i>Some academic doubts about secret reserves</i> .....	29	479
Elder, A. H.,—see "Book Review" .....	30	344
Elliott, C. Fraser, <i>The administration of the Canadian income tax law</i> .....	33	268
Ellis, Cecil A., <i>The control and valuation of stores</i> .....	31	425
— <i>Good systems and fraudulent practices</i> .....	34	355
England, Robert, <i>The gods of the copybook headings</i> .....	31	346
Fanshaw, A. J. J., <i>Some thoughts on the balance sheet</i> ..	29	346
Ferguson, W. S.,—see "Book Review" .....	32	405
Ferrie, G. C., <i>Basic inventory values for certain industries</i> ..	30	124
Firstbrook, W. G., <i>On the audit of executors' accounts</i> ...	27	8
Fleming, A. Ian, <i>Some aspects of investment trust administration in Canada</i> .....	34	101

	VOLUME	PAGE
Foster, A. P.—see "Book Review" .....	30	345
Freeman, George R., <i>Constructive accountancy</i> .....	29	257
Fricker, Eric, <i>Bank of Canada—Notes on its organization and accounting system</i> .....	29	33
Gardner, Robert W., <i>Marine insurance and average</i> .....	34	11
— <i>Wheat production costs</i> .....	34	165
George, H. Wyburn, <i>Some thoughts on taxation of mining companies</i> .....	34	92
Glassco, J. Grant, <i>Business investigation</i> .....	29	430
— <i>Lawyers' accounts</i> .....	31	19
Gordon, W. L., <i>Income taxes, succession duties and other direct taxes in Canada, the United States and Great Britain</i> .....	32	261
— <i>Personal income taxes and succession duties in Canada, Great Britain and the United States</i> .....	30	397
Gow, J. T., <i>A question of realized profits</i> .....	33	60
Gracey, Robert D., <i>High standard in the appearance, content and grammatical construction of accountants' reports</i> .....	32	372
Grant, H. C., <i>The background of the wheat problem</i> ....	27	153
Greene, H. F., <i>Technical preparation for accounting examinations</i> .....	30	445, 503
Greenwood, K. E., <i>Audit of brokerage houses—A system devised to reduce the routine</i> .....	32	20
— <i>Hospital accounting—Departmental analysis</i> .....	30	24
Hackett, W. T. G., <i>The Australian recovery plan</i> .....	28	18
Hallamore, A. S., <i>The effect of fixed costs on profits</i> .....	34	17
Halsey, Sir Laurence, <i>The position of the public accountant in relation to business and government in Great Britain</i> .....	33	353, 434
Hamilton, Mayne D., <i>Canadian banking</i> .....	29	375, 458
Hamilton, R. W., <i>Income tax—A problem in ethics</i> .....	28	118
— <i>The right to specialize</i> .....	29	190
Harder, Oscar H., <i>Newspaper accounting</i> .....	29	9
Hayman, G. E., <i>The Income War Tax Act</i> .....	27	315
Heaton, Wm. C., <i>The profession in the United States</i> .....	33	351
Hendry, J. R., <i>Food cost accounting</i> .....	31	154
Hensel, Philip H., <i>Accounting and the business executive</i> .....	28	123
— <i>Accounting by tabulating machines</i> .....	30	479
— <i>Advantages and uses of budgets</i> .....	30	11
— <i>Analysis of financial statements</i> .....	32	27
— <i>Corporate reports</i> .....	27	400
— <i>Retail method of inventory control</i> .....	30	223
— <i>The statistical control of business activities</i> .....	32	177
—see also "Book Review" .....	27	365
Herington, Harold P.—see "Book Review" .....	32	404
Holding, W. F., <i>Some thoughts on tax and other government returns</i> .....	34	27
Howard, Milton, <i>Accounting as an aid to industry</i> .....	29	183
— <i>Suggested system for a social welfare agency—Accounts</i> .....	31	39
— <i>The accounts of a small oil refinery</i> .....	34	247
Hunt, Irvin T., <i>Accounts of a mortgage loan company</i> ....	32	428
Ilsley, Hon. J. L., <i>Public service in a democracy</i> .....	33	343
— <i>The income tax division</i> .....	32	120
Inman, M. K.—see "Book Review" .....	32	496

	VOLUME	PAGE
Jamieson & Company, H. T. — see "Book Review" .....	29	498
Johnson, T. Harold, <i>The fruit growing industry of Nova Scotia</i> .....	27	349
Jubien, Arthur E., <i>Advertising agency accounting</i> .....	30	383, 489
Keeping, G. P., <i>International Railway Company v. The Niagara Parks Commission</i> —An accountant's point of view respecting depreciation .....	33	298
—see also "Book Reviews" .....	27	440; 33
Keirstead, W. C., <i>Taxation for school purposes</i> .....	30	129
Kellogg, Paul, <i>Prepare tomorrow's statements today</i> .....	34	273
Kergan, James L., <i>The irrigation problem in Alberta</i> .....	29	284
Kettle, Russell, <i>A few remarks on balance sheets and profit and loss accounts</i> .....	34	410
Kilpatrick, James, <i>Prospectuses of public companies—Behind the scenes</i> .....	32	237
Knowles, C. N., <i>Some elementary aspects of budgetary control</i> .....	33	414
—see also "Book Review" .....	32	55
Knox, Frank A., <i>International accounts with special reference to Canada's balance of international payments</i> .....	29	93, 195, 296, 384
Kynch, Montague W., <i>The province of Saskatchewan</i> .....	31	273
Laing, Stanley B., <i>Depletion in metal mines for income tax</i> .....	32	328
Lattman, Walter, <i>Some difficulties of export trade</i> .....	32	257
Leonard, W. G., <i>The financial records and statements of life insurance companies</i> .....	30	364
Logan, H. A.—see "Book Review" .....	34	139
Lucas, W. L., <i>Brewery accounts</i> .....	33	97
McCallum, John E., <i>Agricultural marketing schemes and the Natural Products Marketing Act</i> .....	28	342
McDonald, George C., <i>Some observations on present [economic] conditions</i> .....	27	34
—The public accounts of Canada .....	30	377
McDougall, J. L., <i>Railway passenger travel</i> .....	29	127
McKague, W. A., <i>Economic design for building</i> .....	30	34
McQuarrie, Hon. J. H., <i>The future of the profession of accountancy</i> .....	27	117
Macgregor, D. C., <i>The Soviet financial system</i> .....	31	173
Macintosh, William, <i>Fund consciousness — A forgotten aspect of commercial accountancy</i> .....	30	188
—The arithmetic of the grain trading account .....	34	326
Mackenzie, M. H. W.—see "Book Review" .....	30	71
Mackintosh, W. A., <i>The [economic] troubles of Europe</i> ..	27	50
Macpherson, L. G.—see "Book Review" .....	31	135
Makin, F. Bradshaw, <i>Problems of Britain's gold</i> .....	32	365
—The Bank of England .....	34	33
—The new technique of exchange control ..	31	94
Mapp, Kris A., <i>Educating our students—What is our responsibility?</i> .....	31	255
—Some problems as between business and government .....	33	192
May, George O., <i>Improvement in financial accounts</i> ..	33	42, 106, 200
—Wider horizons [in accountancy] .....	30	295
Maxwell, W. Russell, <i>Credit</i> .....	28	39

	VOLUME	PAGE
Moffet, Harold S., <i>Accounting for an interurban motor coach company</i> .....	32	160
Montgomery, Robert H., <i>What have we done and how?—An address delivered at the fiftieth anniversary celebration of the American Institute of Accountants</i> .....	31	374
Morgan, Henry, <i>Holding companies accounts</i> .....	28	268
Morrow, T. A., <i>Accounts of executors and trustees (two instalments)</i> .....	28	391; 29 21
Mundie, J. Gray, <i>Presidential address at 1935 annual meeting of The Dominion Association of Chartered Accountants</i> .....	27	280
Nichols, M. E., <i>Our duty to the prairies</i> .....	31	267
Nightingale, F. A., <i>Presidential address at 1938 annual meeting of The Dominion Association of Chartered Accountants</i> .....	33	251
Norman, H. G., <i>Our profession—Quo vadis?</i> .....	33	335
Osborne, J. A. C., <i>Bank of Canada</i> .....	28	195
Parton, John, (Editor, Terminology Department) —see also "Book Review" .....	34	221
Pettit, Holland—see "Book Reviews" .....	31	134, 402
Pierce, Alex. E., <i>The shoe manufacturing industry</i> .....	27	418
Plumptre, A. F. W., <i>The open market operations of the Bank of Canada</i> .....	33	421
Rapoport, M. L., <i>Government regulation of motor transport</i> .....	29	290
Reid, William F., <i>Oil royalties in Alberta</i> .....	33	9
Robinson, Dwight P. (Jr.), <i>Accountants' reports and audited accounts from an investment analyst's viewpoint</i> .....	34	187
Rooke, George C., <i>Economic problems of the prairie provinces</i> .....	27	243
Ross, Douglas L., <i>Bankruptcies and liquidations</i> .....	30	305
Ross, Howard I., <i>The auditor, the client and the public</i> ..	32	229
Saddington, C. W., <i>The dairy industry in Canada</i> —butter .....	29	441
—cheese .....	31	204
—milk .....	28	423
—production records for dairy plants .....	29	103
Saunders, W. J., (Chairman, Magazine Committee, 1937 to date)		
Shaughnessy, E. C., <i>A provincial sales tax</i> .....	33	179
Shepard, A. B., <i>Economic conditions in Canada—Presidential address at 1936 annual meeting of The Dominion Association of Chartered Accountants</i> .....	29	211
— <i>Municipal accounting and auditing</i> .....	28	50
Shiach, Harold A., (Chairman, Magazine Committee, 1935-1937) — <i>Legislation affecting Ontario municipalities</i> .....	28	438
—see also "Book Review" .....	28	76
Sinclair, L. R., <i>Salmon canning and branch accounting principles as applied to salmon cannery accounts</i> .....	33	284

	VOLUME	PAGE
Smalls, R. G. H., (Editor "Students' Department")		
— <i>Differential or marginal costs</i> .....	34	256
— <i>Notes and comments</i> .....		
— <i>The balance sheet and the layman</i> .....	29	362
—see also "Book Review" .....	27	293
Small, Gordon S.—see "Book Review" .....	29	409
Smith, Charles W., <i>Accounting for returnable containers</i> ..	33	17
Smith, G. Meredith, <i>Some problems of accounting in a gas</i> <i>or electric public utility company</i> .....	28	179
—see also "Book Reviews" .....	31 133; 32	206
Smith, Sidney E., <i>Training and education</i> .....	27	235
Smith, V. R., <i>Presenting life insurance statements to the</i> <i>public</i> .....	31	442
— <i>The reaction of life insurance companies to</i> <i>the declining rate of interest</i> .....	29	166
Squire, Fred E., <i>Oil and gas well accounting</i> .....	27	174
Stamp, Lord, <i>The future of the accountant</i> .....	34	344
Swift, Rowland, <i>Depreciation allowance under the Income</i> <i>War Tax Act</i> .....	32	385
Thompson, James C., <i>Social Credit</i> .....	30 115, 247	
Thompson, Robert R., <i>Some suggested reforms to the Dom-</i> <i>inion Companies Act</i> .....	31	188
— <i>The debt of culture to commerce</i> .....	30	48
— <i>The development of the profession of ac-</i> <i>counting in Canada</i> .....	34	171
—see also "Book Review" .....	29	407
Tory, William S., <i>Accounting for municipalities with</i> <i>respect to unnegotiated debentures and de-</i> <i>beture principal and interest in default</i> .....	28	104
— <i>The capital account section of a municipal</i> <i>balance sheet</i> .....	29	175
Towner, J. A., <i>Municipal finance</i> .....	32	170
Tweedsmuir, Baron, (John Buchan), <i>Leisure</i> .....	28	47
Waddington, M. W., <i>Some observations by a newcomer to</i> <i>the gas industry</i> .....	33	30
— <i>Trust company accounting</i> .....	31	366
Wade, C. B., <i>The Dominion Companies Act—respecting</i> <i>the interpretation of section 83 (1)</i> .....	28 256, 359	
Wagner, E. H., <i>Problems of the profession in the United</i> <i>States</i> .....	31	320
Walker, C. E., <i>Company legislation in regard to the ac-</i> <i>quiring of initial capital</i> .....	31	31
— <i>The conservation of the capital fund in the</i> <i>interests of shareholders and creditors of</i> <i>the company</i> .....	31	100
Willcox, Frank, <i>Accounting system for gold mining com-</i> <i>panies prior to production</i> .....	28	316
Williamson, Rutherford, <i>Costing and control in a shoe</i> <i>manufacturing business which operates its</i> <i>own retail outlets</i> .....	32	81
Wilson, John A., <i>Fixed asset appraisals and accounting</i> ..	30	97
Winspear, F. G., <i>Some aspects of agricultural accounting</i> ..	27	88
Winter, George E., <i>Presidential address at 1937 annual</i> <i>meeting of The Dominion Association of</i> <i>Chartered Accountants</i> .....	31	247
Wynne, William H., <i>The burden of obsolescence</i> .....	30	312
Young, David—see "Book Review" .....	27	295



